
CHAPTER: Other Activities

SECTION: Nondeposit Investment Sales

Section 710

INTRODUCTION

The risk-focused approach to examining related organizations, as detailed in Handbook Section 730, Related Organizations, allows flexibility in setting the examination scope. The scope must be reasonable and prudent, yet sufficient to evaluate the extent to which a subsidiary poses a risk to the parent thrift. This Section focuses on specific regulatory restrictions, policy standards and safety and soundness concerns associated with securities brokerage activities.

A securities brokerage subsidiary can be an important element of a parent thrift's overall business strategy. It can provide a parent thrift with the potential to increase consolidated earnings, retain customers (certificate of deposit (CD) holders seeking higher returns and investment alternatives), cross-sell its services to provide a full range of financial products, and diversify its investments.

Thus far, thrifts are not directly involved in securities brokerage activities although there is no statutory prohibition against direct sales. Thrifts, unlike banks, are not exempt from the definitions of "broker" and "dealer" under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934. Thrifts would, therefore, be required to register as a broker-dealer to sell nondeposit investment products directly. In the event that a thrift did register as a broker-dealer and received OTS approval to offer such products, the guidelines contained herein would be useful in determining whether the thrift maintains appropriate safeguards. This section applies to the sale of stocks, mutual funds, and variable rate and fixed rate annuities. This section, however, does not apply to sales of nondeposit investment products to nonretail customers, such as sales to institutional customers and fiduciary accounts administered by the thrift. In addition, this section does not apply to pure insurance products such as credit life insurance.

Retail sales, on thrifts' premises, of nondeposit investment products (or "investment products")

have become increasingly prevalent. Thrifts have traditionally conducted such activities through a service corporation subsidiary. In many cases, the subsidiary offers securities brokerage services in the thrift's offices ("on-premises") where deposit taking and other thrift functions are performed. Thrifts usually engage in securities brokerage activities on an "accommodation basis" such as providing customers with access to promotional materials, telephones for placing orders with a broker and limited banking services related to the service corporation's brokerage function, however, they may also directly lease space to a brokerage dealership under certain conditions.

Two primary areas of concern regarding on-premises sales of investment products is the thrift's overall exposure to loss and whether customers fully understand the characteristics and risks associated with such products. Thrift and service corporation management and boards of directors should establish prudent internal controls, such as those described in this Section, to ensure that securities brokerage activities comply with sound business principles as well as applicable regulatory requirements and restrictions. The level of detail contained in internal policies and procedures will depend on the structure and complexity of the brokerage activities.

While the purpose of this Section is to assist regulators when evaluating the effect of a service corporation's securities brokerage program on the parent thrift, the risk assessment issues that are discussed will generally apply to other third party arrangements involving on-premises sales of investment products. You should be aware that some differences do exist. For example, OTS regulations pertaining to service corporations (i.e., activities restrictions and operating standards) do not apply to lease arrangements between a thrift and a third party. Also, customer referral arrangements between service corporations and their parent thrifts are generally not permissible under a thrift/nonsubsidiary lessee relationship.

To determine the level of risk associated with a service corporation's brokerage activities, the regulator must obtain an understanding of the securities brokerage program, applicable OTS policy and regulatory standards and the securities brokerage environment. Specifically, this Section discusses the topics summarized below.

The Business of Securities Brokerage

Securities brokerage firms are regulated at the federal and state levels. The OTS does not review these entities to determine whether they comply with securities rules and regulations. The regulator should, however, evaluate the effect on the parent thrift of a brokerage firm's relationship with its service corporation. The oversight of brokerage firms by securities regulators provides important information in determining the appropriate scope of a service corporation review. The extent to which a service corporation's brokerage program complies with securities laws, rules and regulations can materially affect the entity's viability, the thrift's exposure to loss and the public's overall perception of the parent thrift.

Policy on Sales of Investment Products and Referral Activity

Securities brokerage activities and related customer referral practices that occur on a thrift's premises must be performed in a manner that is consistent with the interagency policy detailed in Thrift Bulletin (TB) 23-2. The bulletin sets forth operating safeguards that management must implement to clearly distinguish insured deposits from uninsured investment products in order to minimize customer confusion and the overall level of risk presented to the thrift. Additionally, OTS regulatory requirements and restrictions that apply to specific aspects of on premises securities brokerage activities are also discussed (i.e., transactions with affiliates, relationships with service corporation subsidiaries).

Service Corporations' Securities Brokerage Program

Securities brokerage activities conducted through a thrift's service corporation must be limited to those that are preapproved or specifically author-

ized by the OTS. The brokerage program must comply with OTS regulatory requirements (i.e., maintenance of separate corporate identities, usurpation of corporate opportunity) that generally apply to all service corporations as detailed in Handbook Section 730. Service corporations, unless operating as an independent brokerage operation, generally use third parties to sell, market, or otherwise provide brokerage services to its customers, but these arrangements must be monitored in a prudent manner. The various aspects (i.e., sales practices, disclosures, advertising) of a service corporation's brokerage activities and potential areas of risk, are detailed throughout this Section.

DESCRIPTION OF SECURITIES BROKERAGE

A detailed discussion of the securities brokerage business and its complex regulatory environment is beyond the scope of this Section. However, the following general information is pertinent to the regulator's review.

How Securities are Sold

Securities in the United States are bought and sold in two primary markets: the over-the-counter (OTC) market and stock exchanges. Service corporations engaging in securities brokerage activities deal in the OTC market. This market consists of a nationwide network of "brokers" and "dealers" who buy and sell stocks and bonds to and from each other and to and from customers. While brokers conduct transactions in securities for the accounts of others, dealers engage in the business of buying and selling securities for their own account. The term broker-dealer describes an entity (i.e., corporation or joint venture) that engages in both activities. A "principal" is an officer or partner of a brokerage firm who is responsible for a certain functional area. Sales persons employed by broker-dealers are referred to as "registered representatives" at the federal level and as "agents" by state authorities. Representatives and agents must be licensed in accordance with applicable federal and state laws.

Types of Brokerage Services

Service corporations are often distinguished as providing either “discount” or “full brokerage” services. A discount brokerage operation generally deals only in buying and selling securities. It offers no investment advice and makes no margin loans (loans that permit securities trades on credit with a deposit of a specified portion of the sales price maintained in a customer account). A full-service broker-dealer offers comprehensive services including investment advice and margin loans in addition to a full range of products.

The two major types of brokerage transactions are agency and principal. The most common type of transaction in service corporations is an agency transaction in which the broker-dealer acts on behalf of a customer only and is compensated through commissions. A principal transaction occurs when the broker-dealer trades securities for its own account.

Investment advice offered through a service corporation may be provided on an individual or standardized basis. Individual advisory services generally involve the assessment, by a registered representative, of a customer’s financial condition, investment goals and other factors to recommend the appropriate mix of investments for the client. Standardized investment advisory services may entail providing one of several categories of advice to an investor based on a determination of what is suitable given that person’s financial status and goals. Such services might include purchase and sale recommendations derived from an independent advisory service or from the principals of the brokerage firm.

There are a number of different ways in which a service corporation can offer securities brokerage services. These range from a very minimal commitment to the formation of a full-service brokerage dealership. The following types of brokerage programs are the most common.

Referral Marketing

This is an arrangement where the employees of the thrift or its service corporation refer customers to a 1-800 telephone number. The number

reaches a broker-dealer that has a contractual agreement with the service corporation. The agreement should stipulate the percentage of the gross commissions that the service corporation is to receive. Service corporation or thrift employee functions are generally limited to handling the transfer of funds between customer accounts and making telephones or promotional material available to prospective brokerage customers.

Turnkey Program

Under this arrangement, the service corporation enters into an agreement to make available customer names, telephones and desk space to a broker-dealer’s registered representatives. In return, the broker-dealer provides the service corporation with a percentage of commissions (generally 50%) generated from the brokerage program. This arrangement typically does not involve substantial, if any, upfront fees to be paid by the service corporation. The registered representatives are exclusively employed by the broker-dealer and all customer contact relating to securities sales occurs through the broker-dealer’s employees. Thus, the broker-dealer must recruit, screen, train, and manage the sales force.

Joint Venture

This is an arrangement between a broker-dealer and the service corporation that generally involves certain start-up costs and various operating expenses (i.e., office and computer equipment, telephone promotional materials, and licensing and training expenses for employees). Registered representatives are usually dual employees of the service or parent thrift and the broker-dealer. A senior officer of the broker-dealer should be responsible for monitoring the registered representatives’ compliance with applicable securities laws and regulations. The percentage of commissions retained by the service corporation should be detailed in a written agreement along with other contractual obligations. (Refer to the discussion of “Third Party Arrangements.”)

Independent Broker-Dealer

A thrift may establish its service corporation as an independent broker-dealer. This arrangement re-

quires a substantial commitment of managerial and financial resources. The financial commitment requires basic start-up costs and continuing operating expenses such as: legal and securities consultation fees, training, various registration and licensing costs, and computer/software costs. A broker-dealer is responsible for registering itself with the Securities and Exchange Commission (SEC) and appropriate state regulatory bodies. The broker-dealer must, among other requirements, become a member of the National Association of Securities Dealers (NASD) and, as a member, is required to meet minimum capital requirements, submit periodic reports, monitor compliance with laws and regulations governing securities brokerage, and obtain required insurance coverages.

Scope of Regulation

Securities transactions in the United States are regulated at the federal and state levels. Generally, federal regulation governs transactions of an interstate nature. State laws may vary in scope, but apply to activities and products transacted within their borders. Broker-dealers are regulated at the federal level by the SEC. They must be registered with the SEC to engage in business on an interstate basis, and must also comply with any registration requirements of the states and self-regulating organizations (SROs) such as those of the exchanges or the NASD.

While broker-dealers and their employees must adhere to registration or licensing requirements, the products that they sell must also be registered. At the federal level, securities must be registered with the SEC. The SEC has no legal authority to determine whether a security is offered to the public. It can only require that an issuer provide adequate, relevant information to enable a potential buyer to make an informed decision regarding the purchase. Additionally, state law generally requires that securities be registered or otherwise approved by state authorities.

Since broker-dealers maintain custody of the funds and securities of their clients, the SEC requires that they show evidence of financial responsibility, and establish mechanisms for customers to recover funds should the broker-dealers

become insolvent or otherwise unable to meet their responsibilities. There are three principal ways in which this is accomplished:

- Net capital rules. Broker-dealers are required to maintain certain levels of capital. These levels generally depend on the activities in which they engage. Many service corporations structure their program to comply with the SEC's policy on networking arrangements so that the net capital rule is not enforced. This generally occurs when a service corporation is associated with a registered broker-dealer. Arrangements between service corporations and third party broker-dealers are very common.
- Handling of customer funds. Broker-dealers must comply with requirements for segregation of customer funds and securities. Thus, broker-dealers must implement adequate measures for ensuring that client and broker funds and securities are maintained separately.
- Maintenance of industry-wide protective fund. The Securities Investor Protection Corporation (SIPC) is responsible for the oversight of this fund. The purpose of the fund is to satisfy claims of customers if a brokerage firm becomes insolvent. This fund is maintained through assessments of members. The SIPC may borrow funds from the United States Treasury in the event that assessments are insufficient to cover its obligations.

Federal and state laws also include anti-fraud provisions that address manipulation of securities trading markets. These laws apply to, among other things, insider trading based on nonpublic information, as well as actions and statements by management designed to deceive others.

As can be seen, broker-dealers must conduct their business in accordance with extensive, and often complicated, federal and state statutes and regulations. The NASD, SEC and state authorities regularly examine broker-dealers. The OTS regulator can consult with appropriate regulatory authorities and request copies of recent examination reports or other records that may be pertinent to the service corporation review. Violations of securities laws or other concerns of securities

regulators should be considered when evaluating the viability of a service corporation's brokerage program and the level of risk presented to the parent thrift.

POLICY ON SALES OF INVESTMENT PRODUCTS AND REFERRAL ACTIVITY

Thrifts, through their service corporations or third party lease arrangements, provide on-premises securities brokerage services to their customers. These services and other program features should be described in a written statement, adopted by management of the thrift or the service corporation, that also contains a summary of internal controls that serve to minimize the level of risk involved.

The OTS's examination authority covers all on-premises sales or recommendations of investment products by a thrift's service corporation or a third party, as well as sales that result from customer referrals for which the thrift receives a benefit. It includes sales of investment products and advisory services initiated from the thrift's premises by telephone or by mail. The purpose of the review is to determine the adequacy of internal controls in containing the level of risk presented to the thrift and minimizing potential customer confusion between FDIC-insured and non-FDIC insured investment products. (Refer to Handbook Section 340, Internal Control, for a detailed discussion of reviewing and evaluating the adequacy and effectiveness of internal controls.)

In providing on-premises securities brokerage services or customer referrals, internal policies and procedures should, at a minimum, incorporate the operating safeguards set forth in TB 23-2, Interagency Statement on Retail Sales of Nondeposit Investment Products. These general safeguards are described below and pertain to the following areas of the brokerage program review:

- Arrangements with third parties;
- Location of on-premises investment advisory and sales activities;
- Advertising and promotional materials;

- Disclosures;
- Sales practices and supervision of personnel;
- Compensation structures; and
- Systems for monitoring operations.

Since the OTS has traditionally only permitted securities brokerage activities through a service corporation, more specific requirements are set forth in 12 CFR § 545.74 and are also discussed in the latter part of this Section. Additionally, 12 CFR §§ 563.41 and 563.42 will apply when a thrift affiliate provides services to the brokerage program through a third party arrangement.

Third Party Arrangements

In light of the substantial costs associated with establishing a brokerage dealership and the extensive securities regulatory environment, the most common situation is for a service corporation to enter into an agreement with an established broker-dealer. The financial and managerial commitment of the service corporation and the level of profits that the entity retains will vary based on the brokerage program's structure, the services involved, and the terms of any written agreement with third parties.

Third parties can offer a full range of investment and administrative services to a securities brokerage subsidiary or a thrift. In providing these services, third parties (i.e., broker-dealers, marketing firms) may consider the thrift's brokerage operation as a conduit for sales, or primarily seek income by charging fees for administrative services.

There are a number of different ways in which a securities brokerage program may be structured. Marketing firms, depending on the needs of the service corporation, may establish and manage the operations or simply provide support functions. Broker-dealers can provide a broad scope of investment products including mutual funds, stocks, bonds, municipal bonds, mortgage-backed securities, annuities, or limited partnerships.

There are essentially two types of third parties that, for purposes of this Section, are referred to

as “nonaffiliates” and “affiliates.” The term affiliate is defined in 12 CFR § 563.41(b)(1). There are general areas of review for determining the risks associated with any third party arrangement. To the extent that a third party is a thrift affiliate, additional OTS regulatory restrictions and policy standards will apply.

Non-Affiliate Third Party Arrangements

Policies and procedures should contain standards for conducting an appropriate review of third parties that offer on-premises investment services and products. These controls should also ensure that the third party arrangements reflect the safeguards contained in TB 23-2 and comply with applicable OTS regulations and restrictions detailed in this Section. Additionally, any third party arrangements should be approved by the service corporation’s board of directors.

Prior to establishing third party arrangements, service corporation management should thoroughly evaluate an entity and the quality of its services and investment products. The evaluation should be performed by personnel with appropriate knowledge, experience and analytical skills. The service corporation’s files should document management’s review of a third party’s services and investment products and internal procedures in this area. For example, management should verify that: (1) the entity’s business is approached with integrity; (2) consumer complaints, if any, are promptly addressed and are not indicative of poor overall operating practices; (3) there is a history of compliance with securities laws and regulations; (4) that disciplinary histories are reviewed; and (5) all the products sold by the vendor meet the criteria set by the board of the thrift or the service corporation.

An adequate review of investment underwriters or issuers and the quality of their products can prevent or limit the number of product liability lawsuits filed against the service corporation and, to the extent the corporate veil is pierced, the parent thrift. Service corporation management can also limit their risk exposure in this area by not offering highly speculative investment products such as commodity futures, real estate partnerships, or junk bonds. If such products are offered,

however, appropriate safeguards (i.e., disclosures, customer/product suitability standards) should be employed to ensure the customer’s awareness of the inherent financial risks of these types of investment products.

After an arrangement is established, the service corporation’s board of directors and management should continue to review the third party’s services and investment products. Ongoing monitoring systems and periodic reporting procedures should ensure that the third party and its employees’ activities comply with all contractual obligations, the thrift’s internal policies and procedures, and applicable state and federal laws and regulations. Internal procedures should describe the types of reports that third parties must provide to service corporation management on a routine basis. Required reports might provide information on new account activity, findings revealed through internal compliance systems maintained by the senior securities principal, and sales activity exception reports that flag potential concerns regarding parameters that have been exceeded or unusual patterns or trends.

Affiliate Third Party Arrangements

While all third party arrangements should be thoroughly reviewed for compliance with regulations applicable to service corporation subsidiaries, arrangements with affiliates must also comply with the following OTS requirements and policy standards.

Transactions with Affiliates

Sections 563.41 and 563.42 (Transactions with Affiliates) place quantitative and qualitative restrictions on loans and certain other transactions entered into by a thrift (or its related organization) and an affiliate. Section 563.42 contains specific restrictions on a thrift’s purchases of securities from an affiliate when the thrift is acting as a fiduciary. In addition, § 563.41 prohibits a thrift, or its subsidiaries, from purchasing or investing in the securities of an affiliate.

Sales of Securities

Section 563.76 of the regulations generally prohibits on-premises sales of a thrift's or its affiliate's securities. A limited exception allows the sale of stock issued in connection with the conversion of a thrift from the mutual to stock form of ownership. TB 23a, Sales of Securities, clarifies this and other limited exceptions to the general prohibition in § 563.76.

Specifically, TB 23a provides that the OTS will not treat investment companies that are sponsored, advised, distributed, or administered by a thrift or its holding company, or a subsidiary of the holding company, as an "affiliate" for purposes of § 563.76.

TB 23a requires, however, that on-premises sales of an investment company's shares comply with safeguards that are comparable to those contained in § 563.76 and TB 23a. [Note: TB 23a provides that the investment company may be treated as a thrift affiliate under certain other regulations such as those that govern transactions with affiliates. Thus, the shares issued by the investment company would be shares of a thrift affiliate.]

Section 563.76 establishes certain requirements for thrifts that engage in on-premises sales of their (or an affiliate's) securities. One such requirement is that the thrift (or an affiliate) may not pay any commissions, bonuses, or comparable incentive compensation to its employees in connection with on-premises sales of its securities. Compensation consistent with industry norms, however, may be paid to securities personnel of registered broker-dealers.

Internal controls and policies should incorporate appropriate safeguards to ensure compliance with the above requirements and general policy standards contained in TB 23-2. Additionally, the OTS has, on a case-by-case basis, imposed additional restrictions on thrifts and their brokerage subsidiaries to address supervisory concerns that are specific to relationships with their securities affiliates.

Written Agreements with Third Parties

The service corporation's files should contain adequate documentation regarding its arrangements with third parties. Written agreements should sufficiently delineate all facets of the arrangement, and must be approved by the service corporation's board of directors. These agreements should, at a minimum, state the following:

- The functions or responsibilities of each party to the agreement;
- The conditions of the arrangement (i.e., activities restrictions, compliance with OTS regulations and policy statements);
- Assurances of compliance with applicable laws, regulations and policies statements;
- The authority of the thrift or service corporation to conduct periodic reviews of the third party's activities to verify compliance with the terms of the agreement;
- Each party's right to participate in profits and obligations to share expenses;
- The types of third party services or investment products to be provided and related restrictions
- Insurance requirements;
- Indemnification provisions; and
- Employee compensation programs and provisions for prior approval by the board of directors of any employment contracts.

A review of the agreements and records pertaining to third party arrangements provides an overview of the securities brokerage operations and reveals potential areas of risk that require further evaluation. Any contract between the service corporation and a third party should contain language that fully indemnifies the subsidiary and its parent thrift from liability attributable to the negligence, recklessness or intentional misconduct of the third party or its employees as required by 12 CFR § 545.74(c)(4)(i) (C).

The thrift may not sign or otherwise be a party to its service corporation's agreement with a third

party. This serves to insulate the thrift from the subsidiary's obligations and ensure that separate corporate identities are maintained. Thrifts may, however, enter into a written agreement to lease a portion of its office space to a nonsubsidiary broker-dealer or, to the extent that such arrangements may be authorized by the OTS, directly engage in securities brokerage activities. [Note: A thrift and its related organizations may not, absent prior OTS approval, engage in the lessee's operations. Also, these arrangements should be based on a bona fide lease and an equitable commission sharing arrangement or provide for the thrift to receive regular, fixed payments that reflect the fair market rental value of the property.]

Service corporation management must be able to demonstrate that internal controls are adequate to monitor a third party's compliance with written agreements. Adequate records pertaining to all brokerage activities should be maintained in a manner that facilitates a prompt review by management and regulators. In determining, for example, whether income is shared in an agreed upon manner, production reports that identify the number and types of sales for the service corporation and for the broker-dealer should be reviewed to determine whether they balance. This is particularly important if remuneration is based in any way on production.

Additionally, third party arrangements should be consistent with representations made to the OTS through the notification or application approval process. The service corporation's files should indicate whether there have been any changes involving third party arrangements since the last examination. A service corporation that terminates a contract with a broker-dealer to enter into a new contract with a second broker-dealer, must file a new notification or application with the OTS. If, however, a third party broker-dealer is acquired by another broker-dealer that assumes its existing contracts, the parent thrift may obtain a no-action letter from the OTS that permits the thrift to change broker-dealers without filing another notice or application.

The business plan of the thrift and its service corporation should also be reviewed to determine whether the third party arrangements are consis-

tent with stated management strategies and objectives pertaining to the subsidiary's operations. Overall, the regulator's review of the brokerage program's agreements and internal controls should reveal whether established procedures, policies and prudent business practices are successfully implemented.

Location of Offices and Informational Materials

Internal controls should also ensure that the brokerage program is clearly distinguished from the thrift's traditional operations for minimizing potential customer confusion. It should be obvious to the casual observer that a brokerage dealership operating on the thrift's premises is a separate organization. For example, a service corporation generally should not conduct on-premises sales of investment products with a name similar to that of the parent thrift, except for conversion stock (see 12 CFR § 563.76), unless internal controls can adequately minimize the risk of customer confusion. As set forth in TB 23-2, investment products must not have a name that is identical to that of the thrift. Similar names are not permitted unless applicable requirements established by the SEC are observed and the sales program is designed to minimize the risk of customer confusion.

Specifically, the following practices should be implemented to ensure that the investment sales area is distinct and that sales literature and material does not convey any inaccurate or misleading impressions about the nondeposit investment products offered.

- The area where nondeposit investment products are offered should be physically separated (i.e., walls, partitions, signs) from teller windows and desks where retail deposit-taking activities are offered;
- Literature and information on investment services should be clearly separate from material pertaining to traditional thrift products (i.e., rates for investment products should be posted separately from checking or certificate of deposit promotional literature, the thrift and

brokerage program should have separate advertisements and pamphlets);

- Signs and literature should clearly state that investment products are not FDIC-insured;
- Statements provided to customers that contain deposit and securities brokerage account information should clearly separate the information and include the required minimum disclosures; and
- Under no circumstances should any employee, while located in routine deposit-taking areas (i.e., teller windows, new account desks), make general or specific recommendations regarding investment products or accept orders for such products.

Maintenance of Separate Corporate Identities

While the above safeguards are prudent business practices, they are also important to ensure compliance with regulatory requirements pertaining to the maintenance of separate corporate identities (§§ 571.21 and 563.37). These requirements are described in Handbook Section 730, and are an important aspect of the service corporation review. To comply with such standards, for example, leasing or rental contracts between a thrift and its subsidiary should be at terms that reflect the fair market value of the space being leased.

Additionally, § 571.21 provides that a thrift and its related organizations should operate without intermingling their respective business transactions, and keep separate accounts and records. It is common, however, for a thrift to provide customer information to its securities brokerage subsidiary. The OTS has not established a regulatory prohibition against this practice, but has taken the position that the securities brokerage subsidiary should comply with the thrift's conditions regarding the use of the parent thrift's customer information. These procedures should comply with applicable state law. On the basis of legal or supervisory concerns, the OTS can, under § 545.74(b), limit access to or use of thrift customer information (i.e., if the information is used in a manner that increases the potential for customer confusion).

When separate corporate identities are not maintained, the parent thrift may be held liable for the contractual obligations of its subsidiary. A review of internal controls and any agreements between a service corporation and its parent thrift or a third party may assist in determining whether separate corporate identities are sufficiently maintained. (Refer to the discussion of "Maintaining Separate Corporate Identities" in Handbook Section 730.)

Content of Advertising and Promotional Materials

Advertising and other promotional materials should be clearly distinguished from that of the parent thrift's depository functions and must comply with the following standards:

- Advertising must not confuse transactions executed and investment advice provided through brokerage operations with federally insured deposits;
- Advertising must clearly state the name of the entity (i.e., service corporation, third party) that it is offering the nondeposit investment products;
- The broker-dealer must be identified in advertising:
 - The parent thrift's logo must not be used in the brokerage program's advertisements; and
 - Promotional material should not omit material facts or mislead customers regarding the characteristics of, and risks associated with, particular investment products.

Advertisements and promotional materials regarding brokerage services should be available to customers in those areas where securities brokerage functions are performed, and may also be placed at branch entrances. When the thrift includes the brokerage subsidiary's materials in mailings that contain thrift customer account statements, these practices should be carefully reviewed to ensure that disclosures are adequate to minimize potential customer confusion and con-

tain the required disclosures as outlined in TB 23-2. For additional information regarding OTS regulations on advertising, refer to Compliance Activities Regulatory Handbook Section 425, Advertising.

Oral and Written Disclosures

Because prospective brokerage customers tend to associate the name and logo of a thrift with the federal insurance that protects their deposits against loss, it is essential that adequate disclosures be made. When the name of the brokerage program (or its investment products) is similar to that of the thrift or its services are offered on the thrift's premises, unsophisticated customers may assume that the investment products are federally insured. For this reason the SEC presumes that similar names promote customer confusion. In order to be permitted to use a similar name, this presumption must be rebutted. (Refer to Appendix A, SEC Policy on Bank Mutual Fund Names).

The potential for customer confusion also increases when references are made, through investment sales presentations or materials, to insurance coverage provided by an entity other than the FDIC (i.e., SIPC, state funds, or private companies). These references should be followed by a clear explanation of the distinctions between such insurance coverage and FDIC deposit insurance. Thrift and service corporation management should ensure that all employees having customer contact receive adequate training on relevant insurance coverages. Internal procedures should also require that written and oral explanations of such insurance coverages are provided to all customers in accordance with established disclosure practices.

Management must ensure that oral and written disclosures are clear, conspicuous, and effective in minimizing customer confusion by fully distinguishing: (1) uninsured products from insured thrift deposits, and (2) brokerage services from deposit-taking functions of the thrift. On-premises sellers of investment products should disclose, in all sales presentations, advertising, confirmation forms, and account statements, the characteristics of the products being offered or sold. Specifically, TB 23-2 establishes the fol-

lowing required "minimum" disclosures that must be provided to customers:

- The products are not insured by the FDIC;
- The products are not deposits or other obligations of the institution and are not guaranteed by the thrift; and
- The products are subject to investment risks, including possible loss of principal invested.

Additionally, internal controls should address standards for providing customers with prudent disclosures regarding any fees, penalties, or surrender charges associated with specific investment products. These controls should also indicate the content and form of customer disclosures pertaining to material relationships between the thrift, its service corporation, an affiliate or an investment company whose shares are sold by the brokerage program.

Internal policies should also ensure that required disclosures are conspicuously stated in all advertisements, sales presentations, or other information (i.e., brochures) pertaining to the features of investment products. Disclosures should generally be presented on the front of a brochure, in the top portion of any text regarding investment products and at the beginning of sales presentations, customer referrals or solicitations. In addition, effective internal procedures in this area would include highlighting the required disclosures in a box, in bold type or with bullet points.

In reviewing the adequacy of internal procedures, the following regulatory requirements and policy standards regarding the timing and form of disclosures should be addressed.

Sales of a Thrift or Thrift Affiliate's Securities

For on-premises sales, 12 CFR § 563.76 requires that purchasers of a thrift's or an affiliate's securities must certify in writing that they have received specific disclosures on the nature of the securities being sold.

Sales of Other Investment Products

The minimum disclosures should be provided to the customer in the following manner:

- orally during any sales presentation;
- orally when investment advice concerning nondeposit investment products is provided; and
- orally and in writing prior to or at the time an investment account is opened.

In addition, at the time an investment account is opened, the seller of investment products should obtain a signed certification from customers acknowledging that the customer received and understands such disclosures. (Refer to the sample certification form attached to “Retail Investment Sales Guidelines for Banks” issued through a joint effort by six financial institution trade associations, including the Savings and Community Bankers of America and the American Bankers Association.)

Customer Referrals by Nonregistered Thrift Employees

Management should adopt standards pertaining to customer referrals by a thrift’s employees to the brokerage operation. Nonregistered thrift employees cannot give investment advice, make general or specific recommendations, qualify a customer as eligible to purchase nondeposit investment products or accept orders for such products, even if unsolicited.

Appropriate Sales Practices

Liability to customers is a primary area of concern in assessing the level of risk presented to the thrift. A broker-dealer that charges excessive mark-ups or makes fraudulent representations of a general nature (i.e., implies that an investment is FDIC-insured when it is not) can be a source of liability to the service corporation and, when separate corporate identities are not maintained, to the thrift as well. The brokerage program must also be conducted in a manner that insulates the

thrift from liability under the anti-fraud provisions of the federal securities laws.

Adequate controls should be implemented to ensure that sales practices are appropriate and that registered representatives comply with management’s internal policies, applicable regulations and restrictions of the OTS and securities regulators. These controls are particularly important to contain risks associated with inappropriate sales practices involving misrepresentations or ineffective disclosures provided to customers.

TB 23-2 and applicable OTS regulations establish minimum standards pertaining to customer disclosures. Risks that are specific to a particular product, the program’s sales techniques, a referral arrangement or relationships with affiliates may require additional disclosures. These disclosures must enable customers to make well-informed investment decisions that serve their own best interests.

There are three primary areas that should be addressed in policies pertaining to sales practices: (1) suitability standards; (2) training; and (3) monitoring systems. Management should ensure that the broker-dealer and sales representatives employ prudent practices in the following areas.

Suitability Standards

The brokerage operation has an obligation to provide customers with products suitable to their needs. Poor or inappropriate investment recommendations attributed to brokerage advisory services will not stand the thrift (or its service corporation) in good stead with the public.

The brokerage program’s policies should document minimum standards that registered representatives must employ to determine whether to recommend a particular investment product to a customer. Such standards require that sales staff obtain sufficient customer information (i.e., age, education, financial and tax status, investment objectives, retirement/financial plans), for making such a determination. For example, an elderly couple that seeks investment products to provide a steady source of income and preservation of capital in the near future should not be advised to

invest their life savings in a highly speculative mutual fund.

The brokerage program's internal controls should require that sellers of investment products comply with applicable "suitability" and "know your customer" standards or related customer protection practices established by securities laws, regulations or the rules of the self-regulating organizations (SROs), such as the NASD. Such standards generally provide that sales representatives should have reasonable grounds for recommending that a certain investment product is suitable for a particular customer. Also, the sales representative must believe that the customer is reasonably capable of evaluating, and financially able to bear, the risks associated with an investment recommendation. Customer information that forms the basis for recommending particular transactions should be thoroughly documented in the brokerage dealership's files and updated periodically.

The broker-dealer should be required to periodically certify that it complies with any applicable suitability requirements and customer protection rules as set forth under 12 CFR § 545.74(c)(4)(i)(D). In addition, service corporation management should document procedures for monitoring the brokerage program's success in complying with established policies pertaining to customer suitability standards. Such monitoring might include periodic reviews of any records on regulatory violations by the company and its sales representatives, customer complaints, or post-audit reviews of a representative sample of transactions. Management should be able to demonstrate that any concerns regarding customer suitability issues have been adequately investigated and resolved (i.e., through training or other actions).

When weaknesses in internal controls are revealed, the regulator should review management reports to identify patterns in order to evaluate concerns regarding appropriate sales practices (i.e., whether a significant number of mutual fund redemptions have occurred after fairly short holding periods). To select sales for review, the regulator should consider patterns related to, for example, specific marketing strategies (i.e., de-

signed for retirees), new account activity, customer complaints, or the performance of representatives with low or high levels of sales activity.

Concerns pertaining to specific sales patterns may require further review beyond customer suitability issues. For example, based on a review of relevant reports maintained by the broker-dealer, a substantial number of "early" mutual fund redemptions may be attributed to improper practices by individual registered representatives, a problem with the investment product, or deficiencies in the employee training program.

Training

In addition to monitoring sales practices, service corporation management can minimize the thrift's exposure to loss by ensuring that employees are adequately trained. Internal policies should establish minimum qualifications and training procedures for the distinct types of brokerage personnel. Management controls should ensure that third party broker-dealers and their employees are appropriately registered with the SEC, NASD, and state securities regulators. In addition to qualifications and training required by securities regulators, brokerage personnel must obtain adequate knowledge in the following areas:

- products involved, including applicable legal restrictions;
- internal policies and procedures of the service corporation and its parent thrift; and
- OTS requirements and restrictions.

Limitations on an employee's authority, proper disclosure practices, and customer suitability standards should be set forth in training materials. Internal policies and records should clearly describe the responsibilities and specific authority assigned to each "type" of employee (i.e., clerical, registered sales representatives, supervisor). Documentation should also indicate the manager responsible for supervising specific employees or types of securities brokerage activities. At a minimum, training material and brokerage policies should address the following areas:

General Restrictions on Sales Representatives' Practices

Brokerage employees should not, without prior OTS approval, engage in the following activities:

- make recommendations regarding securities of issuers that have lending relationships with the thrift, its subsidiaries, or affiliates;
- solicit transactions in specific securities from customers; and
- condition the execution of securities transactions on a customer's use of the service corporation's or a third party's safekeeping services (i.e., holding or transferring actual securities on behalf of the customer).

Training materials should also ensure that sales representatives are thoroughly familiar with overall permissible brokerage activities that are preapproved or specifically authorized by the OTS or FDIC. Operating restrictions and standards imposed by the OTS or FDIC through supervisory letters, approval orders or policy statements should be reflected in internal policies and procedures. For example, standards pertaining to permissible conduct by registered securities brokerage employees should generally be limited to:

- soliciting interest in the program's overall investment products and advisory services;
- making recommendations in response to a request by a customer; and
- not recommending specific nondeposit investment products through "cold calls," or unrequested contacts with a potential customer. [Note: This is not a prudent practice since can be no reasonable determination as to customer suitability concerns nor the individual's ability to understand the product's features and financially bear related investment risks.]

In addition, a broker-dealer may limit various classes of personnel (i.e., based on their qualifications and training) from offering their own assessment of the market or making recommenda-

tions based on their perception of the customer's investment needs. When a customer raises a question or seeks advice on a matter beyond the knowledge or authority of the representative to answer, the employee should forward the customer's request to registered securities principals (either on-premises or an off-site information center) with expertise in that area. Training programs must, therefore, ensure that employees understand the limits of their authority.

Registered Representatives that are Dual Employees

As mentioned, joint ventures and other arrangements between the service corporation and a third party broker-dealer may staff sales operations with individuals that are also employed by the parent thrift. These individuals are referred to as dual employees. The potential for customer confusion is greater when dual employees have customer contact on behalf of both the thrift and the brokerage subsidiary. Thus, additional safeguards may be appropriate to address such risk. Policies and employee training material should include activities restrictions and responsibilities that apply to brokerage employee functions. For example, dual employees should not, while located in routine deposit-taking areas (i.e., teller windows), make general or specific recommendations regarding investment products, or accept any orders for such products.

Nonregistered Employees

Employees that are not registered representatives may perform brokerage functions that are ministerial or clerical in nature. When the brokerage program is conducted through a service corporation subsidiary, prior OTS approval is required under 12 CFR § 545.74(c)(4)(ii)(G) for these employees to engage in additional responsibilities. For example, nonregistered employees may not, under § 545.74, accept or deliver money or securities nor take orders to execute securities transactions. Thrift employees (sole or dual) may, in accordance with thrift policies, refer customers to individuals who are designated and trained to assist customers interested in securities brokerage services.

Thrift Employees

OTS allows tellers and other employees to refer customers to individuals who are specifically trained and designated to assist customers interested in the purchase of investment products. The thrift's internal policies should clearly state that tellers may not sell nondeposit investment products nor offer investment advice to customers by making recommendations or discussing the features of such products. There are additional restrictions on their activities and all employees with customer contact regarding investment services should be trained to observe the boundaries of permitted activities.

Use of the Thrift's Customer Information

Employee training materials should describe the brokerage program's procedures on the appropriate use of the thrift's customer information and identify which employees are authorized to use the information. These materials should address specific steps for minimizing customer confusion when the information is used to contact thrift customers whose CDs are due to mature. Specifically, such contacts should be conducted in a manner that alerts customers to the features and risks associated with nondeposit investment products and that the products are not offered by the thrift nor FDIC-insured.

Monitoring Systems

As stated above, thrift or service corporation management should conduct an initial review of broker-dealers prior to entering into any written agreements. Once an agreement is established, systems should be implemented to review a broker-dealer's activities. For example, a periodic review of consumer complaints can reveal deteriorating trends in a broker-dealer's business practices (i.e., misrepresentations, poor disclosures) and the quality of investment-related products. Information on consumer complaints against the service corporation or a third party broker-dealer might be available from the Better Business Bureau and other consumer organizations. Also, the OTS Consumer Complaint System will indicate whether any complaints have been filed with the OTS.

Standards for reviewing the conduct of individual sales representatives and identifying sales patterns should be documented in the written procedures adopted by the service corporation's board of directors. These standards should establish as part of the comprehensive monitoring system and might provide for:

- routine daily management and oversight of sales representatives by the broker-dealer;
- requirements relating to prior management approval for opening new accounts or executing transactions that exceed a certain dollar amount;
- exception reports that identify transactions that exceed established parameters;
- compliance with applicable rules and regulatory requirements of the OTS and securities regulators; and
- periodic comprehensive reviews of sales representatives' practices (i.e., sampling transactions for compliance with customer/product suitability standards, surveying customer satisfaction through questionnaires, evaluating the nature of any customer complaints or disciplinary actions initiated by securities regulators).

Management's controls with respect to the security brokerage process should ensure that the service corporation's business is conducted in accordance with applicable regulatory constraints and supervisory restrictions. Adequate oversight procedures for monitoring sales practices can reveal unethical and illegal practices such as the "churning" of customer accounts (i.e., causing the rapid turnover of a client's accounts for the sole purpose of earning commissions).

Compensation Structures

The structure of compensation programs should also minimize the potential for abusive practices. The incentive compensation structures adopted by service corporation management tend to be similar to those found throughout the securities industry. Compensation structures for each class of personnel should be established in written poli-

cies and procedures and be available for review by the regulator. The brokerage program's compensation structures should be clearly separate from those of the thrift.

Registered representatives may receive incentive compensation, such as commissions, bonuses, and awards provided their practices are prudent and comply with brokerage program's policies and procedures regarding, for example, customer suitability considerations and adequate disclosures.

Management should be able to demonstrate that compensation paid to dual employees is reasonable. Internal policies and procedures should identify whether commissions and bonuses are available to dual employees, and all employees with customer contact regarding investment services should be trained to observe the boundaries of permitted activities.

Tellers and other thrift employees may receive fees for referring customers to the securities brokerage subsidiary, however, only a one-time nominal fee may be received for each referral. (See Appendix B.) Compensation and referral fees paid to dual and sole brokerage employees can be of concern insofar as these may bias employees to refer business to the securities products rather than those of the thrift. Such incentives may also result in aggressive sales practices. Management should monitor investment product sales activity for individual sales representatives and evaluate whether any patterns reveal improper practices (i.e., concentrations in the types of products sold that may indicate whether recommendations are driven by incentive compensation).

Internal controls throughout all aspects of securities brokerage activity are important to ensure that incentive compensation programs do not lead to improper sales techniques or unethical tactics in an attempt by sales representatives to reap greater financial rewards. Additionally, compliance and audit personnel should not receive any incentive compensation related to the brokerage program's operations. On the basis of supervisory or legal concerns, the OTS may, under § 545.74 (a) (5), object to any element of a service corporation's compensation program.

Conflicts of Interest

Thrifts and their subsidiaries should develop a policy on conflicts of interest and a code of conduct for their officers and other employees. The policy should address those entities and individuals that are providing services through third party arrangements. Specifically, sales of investment products to trust accounts (or other fiduciary accounts in which the parent thrift exercises discretion) may result in conflicts of interest and are generally prohibited.

(Refer to the Trust and Asset Management Handbook for guidelines on prudent practices pertaining to fiduciary accounts.)

Inventory Risk

The brokerage program faces inventory risk, or risk that the actual securities will be lost or stolen, if kept on the premises. While this is not often a major concern because the broker-dealer is acting for the customer, there are times when the broker-dealer will hold the securities until the customer picks them up. Systems should be in place to ensure that no inventory is maintained, and that safety measures are taken for the transportation of securities. Procedures should also be employed to prevent securities orders from being lost.

ASSESSMENT OF SERVICE CORPORATIONS' SECURITIES BROKERAGE OPERATIONS

In addition to determining whether management has successfully implemented the safeguards detailed in TB 23-2, the service corporation's operations must be reviewed for compliance with 12 CFR § 545.74. To facilitate OTS examinations, as well as audits, 12 CFR § 563.170 requires that service corporations establish and maintain adequate records that provide an accurate and complete picture of all business that the entity transacts. Information pertaining to the service corporation's operations can, therefore, be obtained from the service corporation's files and interviews with the securities principal responsible for brokerage program oversight. A review of these files should provide an understanding of the risk assumed by a service corporation and a basis

for evaluating the adequacy of management's risk containment measures.

Section 545.74(c)(4) sets forth the operating restrictions that apply specifically to a service corporation's securities brokerage activities. Additional regulatory requirements that generally apply to all service corporation activities (i.e., investment limitations, financial reporting standards, notification procedures) are detailed in Handbook Section 730.

Preapproved Securities Brokerage Activities

A service corporation may only engage in securities brokerage activities that are preapproved or have been authorized by the OTS or FDIC. Section 545.74 (c)(4) lists preapproved securities brokerage activities and pertains solely to a federal thrift's authority to conduct such operations through a service corporation. State laws should be consulted to determine whether similar authority exists for state-chartered associations. As detailed in Handbook Section 730, a state savings association's authority to conduct activities through a service corporation generally may not, under 12 CFR § 303.13, exceed those permissible for a federal thrift unless prior FDIC approval is obtained. The scope of preapproved securities brokerage activities is limited to the following categories of services: (1) executing trades on an agency and riskless principal basis and (2) investment advisory services.

For securities brokerage activities to qualify as preapproved, the service corporation must, to the satisfaction of the regulator, comply with the following requirements established in § 545.74 (c) (4) (i).

- Activities must be conducted in a physical area that is clearly identified and distinguished from the areas where the parent thrift's depository functions are performed. Areas may be physically defined in various ways including the use of partitions, plants, platforms and kiosks. Advertising must also distinguish a subsidiary's services from those of the parent.
- Third party broker-dealers must indemnify the service corporation and parent thrift for any li-

ability arising from the negligence, recklessness or intentional conduct of the broker-dealer or its employees.

- The senior securities principal of the brokerage dealership must maintain adequate systems and controls that detect and prevent any violations of applicable securities laws or rules of the SROS. Annual certifications that such systems are maintained and that the brokerage program complies with applicable securities rules and regulations must be filed with the OTS.
- The service corporation or broker-dealer must not condition or tie the provision of brokerage services to a customer's use of its services or those of an affiliate of its parent thrift.

A brokerage subsidiary that limits its operations to preapproved activities can, nevertheless, present material risk to the parent thrift. This risk increases when management is negligent in implementing or maintaining adequate operating controls and monitoring procedures. The service corporation's management should be able to demonstrate that the brokerage program operates within the scope of activities that are preapproved or specifically authorized.

Activities Not Authorized as Preapproved

A service corporation's parent thrift must file an application to seek prior OTS authority to engage in an activity that is not preapproved. (Refer to "Other Reasonably Related Activities" in Handbook Section 730.) The OTS has, for example, on a case-by-case basis allowed service corporations to engage in the underwriting and marketing of mutual fund shares or products of an investment company. Section 545.7i (c) (4) (i) specifically states that the following activities are not authorized as preapproved:

- executing principal securities transactions, making markets in securities or underwriting securities;
- paying referral fees to the parent thrift's employees unless a "no-action" letter is obtained from the SEC and prior OTS notice is provided regarding the size and manner of referral

fee payments. (The SEC no longer issues individual no-action letters. (See Appendix B.))

- soliciting transactions in a particular security;
- indemnifying a broker-dealer to a greater extent than the service corporation is being indemnified;
- extending margin credit to investors; or
- allowing nonregistered representatives to engage in other than clerical and ministerial work.

Management must be able to demonstrate that all securities brokerage services are conducted in accordance with the stated purpose of the service corporation, any OTS approval order or representations made to the OTS through the notification process, and the applicable regulatory and policy standards discussed throughout this Section. The OTS Thrift Information Exchange Systems (TIES) is a source of information for obtaining nonstandard approval conditions for a specific service corporation application.

In addition to any OTS operating restrictions, a thrift subsidiary that operates as a broker-dealer must also comply with SEC rules and regulations, including registration requirements. When the service corporation itself is not a broker-dealer, and establishes a referral fee program instead, it must comply with the SEC's policy on networking arrangements to legally receive referral fees and rely on the broker-dealer for all technical matters relating to securities. This policy pertains to whether depository institutions (including thrifts and their service corporations) themselves, or their nonregistered employees, are required to register as broker-dealers when brokerage services are offered on their premises.

Prior to establishing a service corporation referral fee program, under § 545.74(c), the parent thrift must obtain an SEC no-action letter. This letter ensures that enforcement action will not be initiated against the thrift, its subsidiary and nonregistered personnel for failing to register with the SEC. The SEC, however, no longer provides such letters and instead has issued a comprehensive no-action letter, in *Re Chubb Se-*

curities Corporation, dated November 4, 1993. This letter represents the SEC's policy on networking arrangements and applies to all referral fee programs established by depository institutions and their subsidiaries. (See Appendix B, SEC Policy on Networking Arrangements.)

In light of the change in SEC policy, the OTS will not enforce the no-action letter requirement when the following criteria are met:

- the parent thrift must provide an opinion from counsel or the senior securities principal responsible for brokerage program oversight, with subsequent certification from the thrift's board of directors, that any referral fee arrangement complies with applicable SEC regulations and policies; and
- the regional office has no supervisory objections to the referral fee arrangement.

Under the SEC's policy, referral fees paid to non-registered employees must (1) be nominal and unrelated to the volume of securities traded by the customer, (2) be limited to one fee per customer referred, and (3) not include other compensation such as trips, free meals, or monetary awards. The broker-dealer must also provide manuals on appropriate conduct to nonregistered employees that specify the limits on their permissible activities. Additionally, supervisory employees must not receive any fees for referrals made by their subordinates.

As can be seen, the risks presented to the parent thrift by its brokerage subsidiary can vary among the distinct types of brokerage programs. Thus, an understanding of the service corporation's approach to brokerage operations can assist the regulator in identifying potential areas of risk and establishing an appropriate scope of review. Since service corporation brokerage operations typically involve referral fee arrangements, the competence of third parties and the quality of their services/products are an important factor in determining the level of risk assumed by the service corporation.

OVERALL RISK ASSESSMENT

In determining the overall risk presented to the thrift by a securities brokerage program, the basic aspects of permissible securities brokerage activities and management controls for containing risk, as discussed in this Section, should alert the regulator to potential unsafe and unsound practices. Given the different types of brokerage programs and investment products that are offered to customers, the discussion has necessarily focused on general types of brokerage program structures and various risks that can increase the thrift's exposure to loss and lead to customer confusion.

While the procedures that follow relate primarily to the securities brokerage program, the regulator's review of service corporations should also address general business concerns and the areas of review detailed in Handbook Section 730, Related Organizations. The extent to which procedures are performed will depend on a number of factors, including the types of securities brokerage activities, specific products offered, relationships with affiliates, third parties and the parent thrift, the size of the business, and those factors detailed in the Related Organizations Section.

It should be kept in mind that it remains common for securities firms to be established in periods of high trading volumes, and to do well during those times. They may, however, suffer cutbacks or go out of business when volume declines. Therefore, it is appropriate to evaluate the service corporation's future prospects for weathering the storms of the markets, and any measures that have been taken to prepare for the next low point in the cycle. Management expertise and competence is an important factor in assessing the service corporation's long-range planning strategies.

REFERENCES**United States Code (12 USC)***Home Owners' Loan Act*

§ 1464(c)	Loans and Investments
§ 1464(q)	Tying Arrangements
§ 1468(a)	Affiliate Transactions

§ 1468a	Advertising
§ 1468b	Powers of Examiners

Federal Deposit Insurance Act

§ 1828(m)	Activities of Thrift Subsidiaries
§ 1831e	Activities of Savings Associations

Code of Federal Regulations (12 CFR)*FDIC Rules and Regulations*

§ 303.13(0)	Notice of Acquisition or Establishment of a Subsidiary or the Conduct of New Activities Through a Subsidiary
§ 303.13(g)	Notice by Federal Associations Conducting Grandfathered Activities

OTS Rules and Regulations

§ 545.74	Service Corporations
§ 545.74(c)(4)	Securities Brokerage Services
§ 545.77	Real Estate for Office and Related Facilities
§ 545.78	Leasing
§ 561.4	Affiliate
§ 561.45	Definition of a Service Corporation
§ 561.46	Definition of a Service Corporation Affiliate
Part 563g	Securities Offerings
§ 563.33	Selection of Directors and Officers
§ 563.37	General; Operation of a Service Corporation Liability of Savings Associations for Debt of Service Corporations
§ 563.41	Loans and Other Transactions with Affiliates and Subsidiaries
§ 563.42	Additional Standards Applicable to Transactions with Affiliates (Section 23B)
§ 563.76	Offers and Sales of Securities at an Office of a Savings Association

§ 563.132	Securities Issued Through Subsidiaries	Office of Thrift Supervision Bulletins	
§563.170	Examinations and Audits; Appraisals, Establishment and Maintenance of Records	TB 23a	Sales of Securities
§ 563.171	Compensation	TB 23-2	Interagency Statement on Retail Sales of Nondeposit Investment Products
§ 571.7	Conflicts of Interest	TB 23-3	Joint Interpretations of the Interagency Statement on Retail Sales of Nondeposit Investment Products
§ 571.21	Separate Corporate Existence of a Service Corporation		
Other Reference		TB 31-2	Application of Securities Offering Rule to Material for Offerings of Debt
Retail Investment Sales Guidelines for Banks, issued jointly by the six National bank trade associations (January 1994)			

Nondeposit Investment Sales Program

Examination Objectives

To determine the level of risk that securities brokerage activities present to the thrift and to recommend corrective actions as necessary.

To determine whether the required disclosures are made to customers.

To determine the effectiveness of internal controls that distinguish the securities brokerage program from the thrift's traditional activities.

Examination Procedures

Pre-Examination Analysis

Wkp. Ref.

1. Review a copy of:
 - The most recent NASD, SEC or state examination report(s) and any reports pertaining to customer complaints or disciplinary actions initiated by securities regulators against the broker-dealer or any of its employees;
 - The NASD and state regulatory license for each state in which the securities brokerage program operates;
 - The production and financial reports for the securities brokerage program and any associated third party;
 - Reports pertaining to internal compliance reviews;
 - The most recent public accounting report;
 - All written agreements and conditions of approval pertaining to the securities brokerage program; and
 - Thrift Financial Report Schedule CSI-Mutual Fund and Annuity Sales.

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2. Determine the types of activities that the brokerage program engages in, its structure (i.e., lessee, joint venture, turnkey, referral) and the investment products offered (i.e., mutual funds, annuities, equity securities).

-
3. Verify that the association received OTS approval prior to engaging in securities brokerage activities and is in compliance with approval conditions.
-

Sales of Investment Products and Referral Activity

Level I

Internal Controls

4. Determine if internal policies and procedures have been approved by the appropriate board of directors (service corporation or thrift) and whether they are sufficiently detailed.

-
5. Verify that the senior securities principal maintains adequate systems to detect and prevent any violations of securities, laws, regulations or rules.
-

Third Party Arrangements

6. Verify that agreements with third parties exist, and determine that:
- a. They were approved by the appropriate board of directors (service corporation or thrift);
 - b. They contain, at a minimum, provisions that address the following:
 - The functions and responsibilities of each party;

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- Compliance with applicable securities laws, rules and regulations;
 - The conditions of the arrangement (i.e., activities restrictions, compliance with OTS regulations, policy statements, and management's internal controls);
 - Access to the third party's records;
 - Indemnification of the thrift (and its service corporation, if applicable) for potential liability resulting from the actions of its employees; and
 - Employment contracts offered to dual employees.
- c. If the third party agreement is between the thrift's subsidiary and a third party, verify that the thrift is not a party to the agreement.

-
7. Determine whether the thrift (or its service corporation) has established adequate procedures for evaluating third parties and the quality of their services or investment products.
- Is the evaluation performed by personnel with appropriate knowledge, experience and analytical skills?
 - Are the procedures sufficient to ensure that the third party is financially stable and approaches its business with integrity? (Are consumer complaints reviewed along with any examination reports of the appropriate regulator(s)?)
 - Do records document periodic assessments by management of the quality standards and monitoring systems used by the senior securities principal for each type of investment product? (Is a nationally recognized rating system or a thorough analytical process used?)
-

Location of Offices and Investment Sales Activities

8. Determine whether prudent internal controls are employed to ensure that it is obvious to prospective customers that securities brokerage services are offered by a separate entity, not the thrift, and determine whether:

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- The area where nondeposit investment products are offered is physically separate from teller windows and other areas where retail deposit-taking activities are offered;
- Literature and information on investment services are located in areas that are clearly separate from material on traditional thrift products (i.e., the brokerage program's signs and advertisements are not located at teller windows, rates for products are posted separately); and
- Employees, while located in the routine deposit-taking areas (i.e., teller windows, desks where CDs can be purchased), are not permitted to make any recommendations regarding nondeposit investment products or engage in any activities related to offering or selling such products.

Content of Advertising and Promotional Material

9. Determine whether the brokerage program's advertisements and other promotional materials are clearly distinguished from that of the thrift's depository functions and are not misleading.
 - Do materials contain the thrift's logo or terms such as "guaranteed" or "no risk" or other misleading terms?
 - Is the entity offering the nondeposit investment products identified as the seller as required?

Note: If a concurrent compliance examination is scheduled that includes Section 425, Advertising, simultaneous review should be considered as these examination procedures overlap.

Oral and Written Disclosures

10. Determine the adequacy of disclosure policies through a review of training manuals, internal policies and materials available to customers (i.e., advertisements, brochures, prospectuses, offering circulars). Any "No" answers violate OTS policy.
 - a. Do procedures ensure that the required minimum disclosures are provided to customers: (1) the products are not insured by the FDIC, (2) the products are not

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deposits or other obligations of the institution or guaranteed by the thrift, and (3) the products are subject to investment risks, including possible loss of principal invested?

- b. Are the required minimum disclosures made:
- Orally during sales presentations or when advising customers on investment products?
 - In writing prior to or at the time an investment account is opened?
 - Conspicuously, such that disclosures are: (i) located on the front of materials, in the top portion of text or at the beginning of sales presentations, customer referrals or solicitations, or (ii) highlighted in a box, with bold print, or with bullet points?
- c. Are all fees, penalties, or surrender charges listed?
- d. Do disclosures accurately identify material relationships between the brokerage dealership and an affiliate or investment company whose shares are offered to customers?
- e. Are prospective customers advised to review information such as offering circulars or prospectuses before purchasing an investment product, if required by law, rule or regulation?
- f. Are any references to insurance coverage provided by an entity other than the FDIC (i.e., SIPC, state funds or private companies) followed by a clear and accurate explanation of such coverage?
- g. Are customers required to sign a certification form acknowledging the characteristics of, and disclosures received about, nondeposit investment products?

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Similar Names

11. Determine whether thrift management can demonstrate that applicable SEC requirements are observed when the name of investment products is similar to that of the thrift. (Refer to Appendix A, SEC Policy on Bank Mutual Fund Names.)

Use of a Thrift's Customer Information

12. Determine the adequacy and appropriateness of internal procedures regarding the use of the thrift's customer information by the broker-dealer. "Yes" answers are appropriate.
- Does the policy comply with applicable state laws?
 - Is it clear that only designated personnel may use the information?
 - Are adequate measures taken to minimize potential customer confusion when, for example, the information is used to contact holders of CDs that mature in the near future?

Compensation

13. Confirm that the senior securities principal has established internal policies that describe the authority, responsibilities, and method of compensation for each class of personnel and that a supervisor has been designated for each area of the brokerage program's operations.
14. Determine whether internal controls serve to detect and prevent improper sales techniques or unethical practices attributable to incentive compensation programs.
- When bonuses are offered as additional incentives, assess whether qualifications for the bonus increase the potential for aggressive sales practices or unethical practices (i.e., churning of accounts, providing misleading information). (Are bonuses dependent upon the sale of specific investment product(s)?)

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Referral Fees and Practices

15. When the thrift is not registered as a broker-dealer, determine whether thrift management can demonstrate that a referral fee arrangement complies with the SEC requirements. (Refer to Appendix B, SEC Policy on Networking Arrangements.)

-
16. Evaluate the adequacy of the thrift's internal policies regarding customer referral practices.
- Do procedures provide for other than a one-time, nominal fee for each referral?
 - Do fees depend on whether a transaction occurs?
 - Are referrals made in a manner that effectively distinguishes investment products from FDIC-insured accounts?
 - Is it clear that tellers are trained in acceptable referral practices and are prohibited from discussing the features of investment products, soliciting sales, or offering investment advice?
-

Dual Employees

17. When dual employees are registered representatives:
- a. Determine the adequacy of safeguards for avoiding customer confusion.
- Are brokerage services performed in areas segregated from retail deposit-taking areas, as required?
 - Do sales staff comply with the requirement that they identify the company that they represent?
 - Are tellers dual employees? Are their teller functions conducted totally separate from securities brokerage activity?

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- b. Determine that compensation arrangements do not provide for inappropriate incentives.

Nonregistered Employees

18. Verify that internal controls ensure that the functions performed by nonregistered brokerage personnel are limited to those of a clerical or ministerial nature and consider whether nonregistered personnel are prohibited from assisting customers in completing forms for brokerage services and providing general investment advice, even if unsolicited.

Training and Qualifications

19. Evaluate whether the thrift's policies and procedures are sufficient to ensure that brokerage personnel are professionally qualified and adequately trained.
- Has the broker-dealer established the qualifications and training requirements for each class of brokerage personnel?
 - Is adequate training provided for each type of investment product that is sold or recommended?
 - Do standards exist to monitor sales personnel such as sampling transactions, or requiring supervisor approval for new accounts and transactions that exceed established parameters?

Suitability Standards

20. Determine the adequacy of the broker-dealer's monitoring systems for ensuring that investment recommendations are "suitable" for a particular customer and determine whether:

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- Recommendations are based on a reasonable assessment of the customer's financial position, objectives, tax status, age, and ability to understand and bear the investment risks;
- Standards are used to recommend products in amounts, and with terms and features, that are consistent with the customer's financial position and goals;
- Supporting documentation is maintained in customer files, updated periodically, and sufficient to provide a prudent analysis;
- Post-audit reviews of a representative sample of transactions are routinely performed; and
- Broker-dealers and their employees periodically certify that they comply with applicable rules of the SEC, SROs and states.

-
21. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.
-

Level II

Third Party Arrangements

22. Evaluate whether internal controls are effective in monitoring a third party's compliance with the terms of a written agreement. (Do records indicate that commission income is being split in an agreed upon manner? Does the third party pay its own expenses?)
-
23. Verify the financial soundness of third parties that provide services or investment products on the thrift's premises or through an arrangement with a thrift subsidiary
-

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Reviewed By: _____

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Nondeposit Investment Sales Program

Wkp. Ref.

Internal Controls

24. Confirm that internal controls and procedures have been established to ensure compliance with board approved policies and procedures and determine whether:
- The compliance program is independent of the brokerage program's sales function;
 - Post transaction quality controls have been implemented (i.e., exception reporting systems, reviews of customer satisfaction, and internal and external audits); and
 - The compliance program, at a minimum, includes a system to monitor customer complaints, investment sales activity and customer accounts to detect and prevent improper practices.
-
25. Determine whether adequate procedures are established for handling any customer complaints or disciplinary actions initiated by securities regulators.
-
26. Determine the adequacy of internal controls in preventing situations that could potentially lead to a conflict of interest. (Is the conflict of interest policy revised periodically? Is it clear that representatives should not recommend securities issued by entities that borrow from the thrift?)
-
27. Determine whether systems are in place to ensure that no inventory of securities are maintained on the brokerage program's premises. (Do adequate security measures exist for the transportation of securities? Are procedures followed that prevent orders from being lost?)
-

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Nondeposit Investment Sales Program

Wkp. Ref.

Evaluation of Business Plan Projections

28. Determine whether the brokerage program's operating results are consistent with business plan projections and that management periodically addresses long range strategic planning.

-
29. Evaluate the securities brokerage program's operating results and the volume of business against business plan estimates for overall operations and specific types of investment products. (Thrift management should be able to explain material variances.)

-
30. Determine whether management routinely reviews reports on customer mix and market surveys or other appropriate analyses and that the brokerage program's operating projections are supported by adequate documentation.

-
31. Determine whether reports provided to management on nondeposit investment sales activity are sufficient to determine trends or patterns that may require further review (i.e., a substantial number of mutual fund redemptions after fairly short holding periods, concentrations pertaining to specific investment products or types of customers).

-
32. Evaluate the thrift's procedures to implement corrective action in response to internal weaknesses or violations of applicable laws or regulations identified through monitoring systems, internal audits, and examinations by the OTS or securities regulators.
-

Service Corporations' Securities Brokerage Program

33. Perform the appropriate procedures in Handbook Section 730, Related Organizations.

-
34. When reviewing compliance with regulatory requirements specifically applicable to securities brokerage operations conducted through service corporations (12 CFR

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§545.74(c)(4)), management should, unless prior OTS approval is obtained, be able to demonstrate that:

- Securities brokerage activities do not involve executing principal securities transactions, making markets in securities or underwriting securities;
- Referral fees are not paid to the parent thrift unless the brokerage program complies with OTS restrictions and the SEC's policy on networking arrangements (refer to Appendix B, SEC Policy on Networking Arrangements);
- The broker-dealer does not solicit transactions in a particular security;
- The broker-dealer is not indemnified to a greater extent than the service corporation and parent thrift are being indemnified; and
- The service corporation and parent thrift are not extending margin credit to investors.

-
35. When the service corporation is not registered as a broker-dealer, verify that an opinion of counsel, or of the senior securities principal, states that any referral fee arrangement complies with the SEC's policy on networking arrangements as detailed in Appendix B. The opinion should be certified by the thrift's board of directors. (See Appendix B.)
-

Thrifts' Third Party Lease Arrangements

36. When a third party leases space directly from the thrift, confirm that there is a bona fide lease agreement that provides for fair market rent or an equitable commission sharing arrangement. Ensure that the thrift (or its subsidiary) does not engage in the lessee's operations.
-

Third Party Arrangements with Affiliates

37. When third party arrangements involve thrift affiliates, determine whether management can demonstrate that established internal controls are adequate to ensure that the thrift, or

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its subsidiary, complies with the restrictions detailed in §563.41 and 563.42 of the OTS regulations.

-
38. Determine whether on-premises sales of a thrift's securities, or those of an affiliate, comply with the restrictions in 12 CFR §563.76 and are performed in a manner that is consistent with the safeguards listed in TB 23a, Sales of Securities.
-

39. Ensure that the Objectives of this Handbook Section have been met. State your findings and conclusions, as well as appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages.
-

Proprietary Funds

40. Review proprietary fund sales programs to determine that:

- oral and written disclosures are made, prior to the purchase of shares, of all relationships between the thrift, or its affiliates, and the fund; and
 - proprietary funds do not have names identical or similar to the thrift.
-

41. Review compensation arrangements for proprietary funds. Determine the effect of any difference in compensation structure. Review suitability documentation to ensure that compensation is not a factor in determining suitability.
-

42. Determine whether a contingency plan has been established for handling adverse events, such as a sudden market downturn or periods of heavy redemptions.
-

43. Review the association's earnings and evaluate:

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- profitability of activities including any investment advisory fees the association may receive; and
- income and expense from proprietary fund sales, investment advisory and proprietary fund management activities, as a percentage of noninterest income and expense.

44. Review investment history of proprietary funds to determine that:

- fund investments are in line with disclosures given in prospectus; and
- fund investments are appropriate given board investment policies.

45. Review proprietary fund investment portfolios for any structured securities holdings. (Most structured securities are unsuitable for money market funds, such as inverse floaters, cost of funds index floaters, constant-maturity Treasury floaters, dual-index floaters, and range floaters.)

- Check documentation for compliance with investment policy, results of sensitivity analysis (stress testing), evaluation of pricing, and liquidity and credit risk prior to purchase.

46. Review current ratings from rating agencies such as Standard and Poors (S&P is a rating agency of many money market funds). Try to determine if the rating agency has any plans to change (especially downgrade) the current rating.

Examiner's Summary, Recommendations, and Comments

Exam Date: _____

Prepared By: _____

Reviewed By: _____

Docket #: _____

SEC Policy on Bank Mutual Fund Names

**United States
Securities and Exchange Commission
Washington, D.C 20549**

May 7, 1993

The Honorable John D. Dingell
Chairman
Committee on Energy and Commerce
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Dingell:

In response to your request of March 9, 1993, I asked the Division of Investment Management to prepare the enclosed memorandum on Commission and staff actions regarding mutual funds that have the same names as, or names similar to, banks that advise the funds or sell the funds' shares. As you can see, the Commission's staff is of the view that common names are presumptively misleading. A common name fund can rebut this presumption, however, through prominent disclosure on the cover page of its prospectus that the fund's shares are not deposits or obligations of the bank, and are not insured or otherwise protected by the federal government.

I hope this memorandum satisfactorily responds to your questions. If you have any further questions regarding the issues raised in your letter, please contact me, Barbara J. Green, Deputy Director, or Thomas S. Harman, Associate Director, Division of Investment Management.

Sincerely,

/s/Richard C. Breeden
Chairman

Enclosure

MEMORANDUM

May 6, 1993

To: Chairman Breeden

From: Barbara Green, Deputy Director
Thomas S. Harman, Associate Director
Division of Investment Management

Subject: Bank Mutual Fund Names

This memorandum responds to Chairman Dingell's letter of March 9, 1993 in which he asks several questions about what, if any, action the Commission has taken or intends to take to ensure that investors in bank advised or bank sold mutual funds are not misled into believing that their investments are guaranteed or insured the same manner as bank deposits. In particular, Chairman Dingell expresses concern regarding mutual funds that have names that are the same as, or similar to, banks that advise the funds or sell the funds' shares ("common name funds"). Chairman Dingell's questions and our responses are set forth below.

Question 1. What prohibitions or restrictions do current Commission rules and regulations contain with respect to common or shared bank and mutual fund names, and under what authorities? Please explain the rationale for said provisions or the lack thereof.

Section 35(d) of the Investment Company Act of 1940 ("1940 Act") provides the Commission with the authority to issue an order declaring that any word or words that a mutual fund uses in its name are deceptive or misleading. The staff has taken the position under the authority of Section 35(d) that a mutual fund should not use in its name certain generic terms that may mislead investors into believing that the fund's shares are federally insured.¹ The staff also does not permit mutual funds that invest in U.S. Government securities to use terms in their names or advertising that imply that the securities issued by the funds are guaranteed or insured by the U.S. government.²

The Commission previously has not adopted any rules or regulations prohibiting or restricting mutual funds' use of common names. However, after carefully reviewing the risk that mutual funds sold on bank premises could be misconstrued as having the benefit of either federal deposit insurance or the liquidity protections of the discount window of the Federal Reserve, the Division is of the view, under the authority of Section 35(d), that common names between federally insured institutions and funds sold or marketed by or through such institutions are presumptively misleading. A common name fund can rebut this presumption through prominent disclosure on the cover page of its prospectus that the fund's shares are not deposits or obligations of, or guaranteed or endorsed by, the bank, and that the shares are not federally insured or oth-

¹ See e.g., CNA Management Corporation (pub. avail. Nov. 29, 1974) (staff letter objecting to use of "Mutual Savings Fund"); Wright Investors' Service (pub. avail. March 14, 1974) (staff letter objecting to the use of "Savings"); National Securities & Research Corporation (pub. avail. Jan. 21, 1974) (staff letter objecting to use of "Savest"); Ben Franklin Thrift Shares, Incorporated (pub. avail. Sept. 1, 1973) (staff letter objecting to use of "Thrift").

² See Letter from William R. McLucas, Director, Division of Enforcement, and Gene A. Gohlke, Acting Director, Division of Investment Management, to Registrants, October 25, 1990.

erwise protected by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or any other agency.

As noted in response to question 4, the Commission has not taken a formal position regarding whether Section 35 should be amended to restrict or prohibit the use of common names. There is a risk that, no matter how prominent the disclosure, some customers will not appreciate that their investment in a mutual fund sold by or through a bank, especially if marketed in the lobby of the bank, could potentially fall precipitously in value in response to changes in the value of portfolio securities. The staff expects to continue to review the question of whether common names should be barred notwithstanding the level of disclosure, but the staff has not reached any such conclusion at this time.

Question 2. What disclosures are required to prospective customers, and under what authorities? Please explain the rationale for these requirements.

The Division will require disclosure in three situations. First, the staff will require any common name fund to disclose prominently on the cover page of its prospectus that shares in the fund are not deposits or obligations of, or guaranteed or endorsed by, the bank, and that the shares are not federally insured or otherwise protected by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or any other agency. The staff considers a disclosure to be prominent if it appears in some typographically distinct manner (e.g., boldface, italics, red letters, etc.). Second the staff already requires any mutual fund whose shares are sold exclusively by or through a bank to provide essentially the same disclosure on the cover page of its prospectus.³ Finally, the staff will require any bank sold mutual fund to make the same disclosure, even where the fund's shares are not sold exclusively through banks and the fund is not a common name fund.

As stated above, the Division is of the view that common names are presumptively misleading. The authority for requiring these disclosures is the Commission's broad authority to require that a prospectus contain the necessary material information to make the statements contained in the prospectus not misleading.⁴ The policies underlying Section 35(d) provide additional authority to require disclosure with respect to common name funds. In addition, as discussed more fully below in response to question 5, broker-dealers and thrift employees, though not bank employees, are subject to certain disclosure requirements in connection with the sale of mutual fund shares to bank thrift customers.

Question 3. What action has the Commission taken or intends to take in response to the recent adoption by mutual funds of names similar to the banking organizations that advise them? Please explain the rationale.

³ See Letter from Carolyn B. Lewis, Assistant Director, Division of Investment Management, to Registrants (Feb. 22, 1993).

⁴ See Rule 8b-20 under the 1940 Act, 17 C.F.R. 8b-20 (investment company registration statement or report required to include material information in addition to that expressly required if necessary to make the required statements not misleading); Rule 408 under the Securities Act of 1933 ("1933 Act"), 17 C.F.R. 230.408 (any registration statement required to include material information in addition to that expressly required if necessary to make the required statements not misleading); see also Section 10(c) of the 1933 Act, 15 U.S.C. 77j(c) (Commission authorized to adopt rules requiring any prospectus to provide such additional information as necessary or appropriate in the public interest or for protection of investors).

As noted above, the Division is of the view that common names are presumptively misleading. A common name fund can rebut this presumption, however, through prominent disclosure on the cover page of its prospectus that the fund's shares are not deposits or obligations of the bank, that the shares are not guaranteed or endorsed by the bank, and that the shares are not insured or otherwise protected by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or any other federal agency. The Division has reviewed a significant number of common name fund prospectuses and found that a large number already have rebutted the presumption through disclosure. The Division will require that all other common name funds amend their prospectuses in the future so that they will similarly rebut the presumption through disclosure. The Division also is considering whether the rules governing mutual fund advertising should be amended to address issues raised by common name funds.⁵

Question 4. What steps, if any, does the Commission believe are warranted to achieve consistent protection in this area?

As noted above, the Division is of the view that common names are presumptively misleading. A common name fund can rebut this presumption, however, through prominent disclosure on the cover page of its prospectus that the fund's shares are not deposits or obligations of the bank, that the shares are not guaranteed or endorsed by the bank, and that the shares are not insured or otherwise protected by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or any federal agency. Of course, the Division will apply this policy consistently to all registered funds advised by or sold through banks, thrifts of any insured depository institution.⁶ The Commission currently does not have a position regarding whether Section 35(d) or other federal securities laws should be amended to restrict expressly or to prohibit mutual funds from using common names. The Division will continue to monitor this issue with a view towards making any needed recommendations.

Question 5. To the knowledge of the Commission, are tellers and other personnel on bank and thrift premises complying with the applicable requirements? What resources have been committed to ensuring compliance in this area?

Because banks are expressly excluded from the broker-dealer provisions of the Securities Exchange Act of 1934 ("Exchange Act"),⁷ the Commission does not have the oversight authority or the ability to allocate the resources to determine if bank tellers and other bank personnel are complying with the federal securities laws. The Commission's regulatory and oversight authority is limited to the employees of registered broker-dealers, which includes bank subsidiaries and affiliates because the subsidiaries and affiliates are not covered by the bank exclusion. The Commission also has authority over the securities activities of personnel of thrift institutions (and other institutions not covered by the bank exclusion) that enter into "networking" or "kiosk" arrangements with broker-dealers.⁸ These persons are subject to specific restrictions on their activi-

⁵ See e.g., Rule 134 under the 1933 Act, 17 C.F.R. 230.134 ("tombstone" advertisements); Rule 482 under the 1933 Act, 17 C.F.R. 482 ("omitting prospectus" advertising); Rule 34b-1 under the 1940 Act, 17 C.F.R. 270.34b-1 (investment company sales literature).

⁶ The Division recently compiled the attached list of bank-related investment companies with names similar to the bank.

⁷ Sections 3(a)(4) and 3(a)(5) of the Exchange Act exclude banks, as defined in Section 3(a)(6), from the definitions of "broker" and "dealer." See Sections 3(a)(4), 3(a)(5), and 3(a)(6) of the Exchange Act, 15 U.S.C. 78c(a)(4) – 78c(a)(6) (defining "broker," "dealer," and "bank").

⁸ In a "networking" or "kiosk" arrangement, a broker-dealer agrees to provide securities services to the customers of a financial institution on a premises of that institution in exchange for a percentage of the commissions earned.

ties, as set forth in a series of no-action letters, which are described in detail in a staff memorandum forwarded to you by Chairman Breeden on February 19, 1993 (“Memorandum”).⁹ Dual employees of broker-dealers and thrift institutions that enter into networking arrangements, for example, are required to disclose material information to investors about the risk of investing in mutual funds, including the fact that they are not federally insured or guaranteed by the institution. In addition, unregistered personnel of the institution are expressly prohibited from engaging in any sales activities. These important protections for customers are not available to the customers of banks, whose employees are exempt by current law from any similar requirements.

As noted in the Memorandum, to ensure compliance with the no-action letters, during the last fiscal year the Commission staff conducted examinations of several thrift institution networking arrangements, focusing on the broker-dealer’s branch office review procedures, supervision of registered and unregistered employees, advertising, and sales practices. These examinations revealed substantial compliance with the provisions of the Exchange Act and the terms of the individual no-action letters, and isolated compliance problems were effectively addressed. The Commission, however, intends to continue to use its examination authority to monitor the sales practices and supervisory procedures of broker-dealers that sell mutual funds.

In addition, self-regulatory organizations (“SROs”), with Commission support, have taken steps to ensure that broker-dealers and their personnel that sell securities on bank or thrift premises are fully aware of and in compliance with their disclosure obligations under the federal securities laws.¹⁰ Although the Commission to date has not received a significant number of investor complaints about bank mutual funds,¹¹ to supplement the efforts of the SROs, the Commission staff is currently developing educational materials discussing the risks of investing in bank mutual funds and other uninsured products, for future distribution to investors.

Question 6. What are the risks to the insured depository institution in terms of customer backlash and litigation liability if common-name or common-logo funds suffer losses? What steps can be taken or are being taken to eliminate or manage these risks?

We do not know whether and to what extent an insured depository institution would experience “customer backlash” or be subject to litigation if a common-name or common-logo mutual fund suffers losses. We believe that these questions, as well as the question regarding what steps have been or are being taken to address any risks, would be more appropriately directed to the banking regulators.

⁹ Letter from Richard C. Breeden, Chairman, Securities and Exchange Commission, to John D. Dingell, Chairman, Committee on Energy and Commerce, U.S. House of Representatives (February 19, 1993) (enclosing memorandum from the Commission’s Division of Market Regulation regarding reinvestment of proceeds of certificates of deposit in securities products).

¹⁰ The SROs, for example recently announced a plan to develop a single continuing education program for all securities industry registered representatives and principals. See 7 *NASD Regulatory & Compliance Alert*, No. 1 (March, 1993). The National Association of Securities Dealers, Inc. also has implemented initiatives designed to alert broker-dealers to their disclosure obligations when recommending that investors reinvest the proceeds of certificates of deposit in securities, such as bond funds and collateralized mortgage obligations. See e.g., *NASD Notice to Members*, No. 91-4 (November, 1991).

¹¹ The staff has reviewed its files and has not found any investor complaints alleging confusion between mutual fund investments and insured bank deposits.

A bank or thrift would not be liable under the federal securities laws solely because a common-name or common-logo fund whose name is not otherwise misleading suffers losses. The bank or thrift may be liable under the federal securities laws, however, if it commits fraud in connection with the purchase or sales of securities.¹² In addition, a bank or thrift that sells a security by means of a prospectus or oral communication that contains an untrue statement of a material fact or omits to state a material fact may be liable to shareholders for rescission or damages.¹³ Further, a bank or thrift may be liable if it commits a breach of fiduciary duty in connection with its receipt of compensation from an investment company that it advises.¹⁴

¹² See Rule 10b-5 under the Exchange Act, 17 C.F.R. 240.10b-5 (general antifraud provision in connection with purchase or sale of securities).

¹³ See Section 12(2) of the 1933 Act, 15 U.S.C. 771 (2) (liability for use of misleading prospectus or oral communication in connection with sales of a security).

¹⁴ See Section 36(b) of the 1940 Act, 15 U.S.C. 80a-35(b) (breach of fiduciary duty by investment advisor to investment company in connection with compensation received by adviser).

SEC Policy on Networking Arrangements

Office of Thrift Supervision
Department of the Treasury

TO: REGIONAL DIRECTORS

FROM: Carolyn Lieberman
Acting Chief Counsel

SUBJECT: New SEC Policy Re: Referral Fee Program “No-action” Letters

DATE: January 7, 1994

Introduction

The purpose of this memo is to 1) alert you to the Securities and Exchange Commission’s (SEC) new policy to no longer issue individual “no-action” letters to federal associations regarding securities brokerage referral fee programs in service corporation networks arrangements, and 2) in light of interim guidance as to how federal associations may otherwise effect compliance with current OTS requirements to obtain a SEC no-action letter in order to conduct referral fee programs.

Discussion**Current OTS requirements**

The OTS service corporation regulations provide, in pertinent part, that a federal association may acquire or establish a service corporation to engage in certain preapproved securities brokerage activities, provided certain conditions are met.

One of these conditions prohibits payment to any employee of the association of a referral fee, bonus or incentive compensation, in cash or in kind, for referring any thrift customer to the service corporation except as may be consistent with a “no-action” letter received by the association from the SEC, stating that the SEC will not recommend enforcement action if association employees receive the planned fee but do not register as a broker-dealer under the securities laws. See 12 C.F.R. §45.74(c)(4) (ii)(B). As a matter of policy, a similar requirement has been imposed on nonpreapproved service corporation brokerage activities. See Service Corporation Guidelines, Section 710.10, OTS Applications Processing Handbook.

SEC policy change

To date, federal associations have complied with the above described requirement by individually requesting “no-action” letters from the SEC.

The SEC, however, generally will no longer issue no-action letters in this area. In this regard, the SEC's Division of Market Regulation recently issued a comprehensive no-action letter, *In Re Chubb Securities Corporation*, dated November 24, 1993 ("Chubb letter") (attached) which sets forth the SEC's policy regarding networking arrangements between broker-dealers and depository institutions. In connection with issuing Chubb letter, the SEC staff advised OTS that 1) it will not longer respond to individual requests for no-action relief regarding such arrangements, unless a request presents novel or unusual issues, and 2) broker-dealers and depository institutions including federal associations and their service corporations, may relay on the Chubb letter if they structure their networking arrangements in accordance with the terms and conditions set forth in the letter.

Interim guidance

In light of the new SEC policy, OTS will be considering appropriate regulatory and policy changes in this area in the near future. In the interim, OTS will not enforce the no-action letter requirements, provided the following two conditions are met:

1. The applicant provides an initial opinion of counsel or an opinion from the senior securities principal responsible for overseeing the subject brokerage program, with subsequent certification from the applicant's board of directors, that any referral fee arrangement is in compliance with the Chubb letter, and any related SEC regulations and policies. The opinion on this issue may be included in the initial opinion required by OTS from federal associations that propose to establish service corporation brokerage program (re: that the program has been established pursuant to procedures designed to ensure conformity with applicable securities laws and regulations).¹

2. The Regional Director has no other supervisory objections to the proposed referral fee arrangement.

If you have any questions regarding the foregoing, please contact Dean Shahinian, Corporate and Securities Division at (202) 906-7289.

¹ See 12 C.F.R. 545.74(c)(4)(i)(D); OTS Applications Processing Handbook at Section 710.10.

**United States
Securities and Exchange Commission
Washington, DC 20549**

November 24, 1993

Carolyn Lieberman, Esq.
Acting Chief Counsel
Office of Thrift Supervision
1700 G Street, N.W.
Washington, D.C. 20552

Dear Ms. Lieberman:

Enclosed is a no-action letter issued by this office on November 24, 1993, to Chubb Securities Corporation ("CSC"), a registered broker-dealer. In that letter, CSC proposed to enter into networking arrangements with various depository institutions, including federal savings associations and their service corporations, to provide brokerage services of such institutions, without such institutions or their unregistered employees registering as broker-dealers.

The enclosed letter to CSC sets forth our policy with regard to networking arrangements between broker-dealers and depositories institutions. In the future, we will no longer respond to requests for no-action relief regarding such arrangements, unless a request presents novel or unusual issues. Broker-dealers and depository institutions, including federal savings associations and their service corporations, may rely on the letter to CSC if they structure their networking arrangements in accordance with the terms and conditions set forth in that letter.

Sincerely,

/s/ Catherine McGuire
Chief Counsel

Enclosure

**United States
Securities and Exchange Commission
Washington, D.C 20549**

November 24, 1993

Ian E. Celecia, Esq.
Chubb Securities Corporation
One Granite Place
P. O. Box 2005
Concord, New Hampshire 03302

Re: Chubb Securities Corporation

Dear Mr. Celecia:

In your letter of September 1, 1993, on behalf of Chubb Securities Corporation ("CSC"), as supplemented by telephone conversations with the staff, you request assurance that the staff would not recommend enforcement action to the Commission under Section 15(a)(1) of the Securities Exchange Act of 1934 ("Exchange Act") if CSC enters into networking arrangements with certain federal and state chartered banks, savings and loan associations, savings banks, and credit unions (collectively, "Financial Institutions") and, where required by law, their service corporation subsidiaries, to provide securities brokerage services on the premises of such Financial Institutions, as described in your letter, without the Financial Institutions, the required service corporations, or their unregistered employees registering as broker-dealers under Section 15(b) of the Exchange Act.

We understand the facts to be as follows:

CSC, a wholly-owned subsidiary of Chubb Life Insurance Company of America, is a registered broker-dealer and member of the National Association of Securities Dealers, Inc. ("NASD"). CSC proposes to enter into networking arrangements with Financial Institutions to provide securities brokerage services to customers of such Financial Institutions and the general public, on the premises of the Financial Institutions. Where required by the laws or regulations governing a Financial Institution, the Financial Institution will enter into the networking arrangement with CSC through a service corporation subsidiary of the Financial Institution.

CSC will provide brokerage services on the premises of each Financial Institution in an area that is physically separate from the Financial Institution's regular business activities, in such a way as to clearly segregate and distinguish CSC from the Financial Institution. The area in which CSC provides brokerage services will clearly display CSC's name and an indication that CSC is a member of the NASD, and will be registered with the NASD as a branch office of CSC. Under the networking arrangements, CSC will provide brokerage services only on the premises of the Financial Institutions themselves, and not in areas where a service corporation has a location independent of the Financial Institution.

The networking arrangement between CSC and each Financial Institution (including its required service corporation) will be governed by a Customer Access Agreement, which will set forth the responsibilities of the parties, the conditions of the arrangement, and the compensation to be received by the

Financial Institution (including its required service corporation). As a registered broker-dealer, CSC will comply with all statutory and regulatory requirements applicable to broker-dealers, including applicable rules of self-regulatory organizations (“SROs”). CSC will exclusively control, supervise, and be responsible for all securities business conducted in its locations at the Financial Institutions. Under the networking arrangements, transactions in securities may be effected only by registered representatives of CSC, some of whom also may be employees of the Financial Institution, including its required service corporation (“Dual Employees”). CSC will control, properly supervise, and be responsible for all its registered representatives, including any Dual Employees acting in their capacity as CSC registered representatives.

Any materials used by CSC of the Financial Institutions (including required service corporations) to advertise or promote the availability of brokerage services under the networking arrangements will be approved by CSC for compliance with the federal securities laws prior to distribution. All such materials will be deemed to be CSC’s materials, and will indicate clearly that the brokerage services are being provided by CSC and not the Financial Institution or its required service corporation; that neither the Financial Institution nor its required service corporation is a registered broker or dealer; that the customer will be dealing solely with CSC with respect to the brokerage services; and that CSC is not affiliated with the Financial Institution or its required service corporation. References to a Financial Institution in advertising or promotional materials will be for the purpose of identifying the location where brokerage services are available only, and will not appear prominently in such materials.

All confirmation, account statements, and other customer communications regarding securities transactions under the networking arrangements will be sent directly to the customer by CSC or by the issuer, transfer agent, or principal underwriter of the security. All documentation sent by CSC directly to a customer, including confirmation and account statements, will indicate clearly that the brokerage services are provided by CSC and not by the Financial Institution or its required service corporation. If any documentation regarding securities transactions is sent directly to a customer of CSC by an issuer, transfer agent, or principal underwriter, CSC will be responsible for ensuring that such materials comply with the federal securities laws; and the name of the Financial Institution or its required service corporation will not appear on such materials.

Each Financial Institution (including required service corporations) will allow supervisory personnel of CSC and representatives of the Commission, the NASD and other SROs of which CSC is a member, as well as other applicable federal and state governmental authorities, to inspect the Financial Institution’s premises where CSC conducts brokerage activities and any books and records maintained by CSC with respect to brokerage activities. Each Financial Institution (including required service corporations) will be deemed to be an associated person of CSC within the meaning of Section 3(a)(18) of the Exchange Act.

Employees of the Financial Institutions (including required service corporation) who are not registered representatives of CSC will not engage in any securities or investment-related activities on behalf of CSC. Unregistered employees will be prohibited from recommending any security or giving any other form of investment advice, describing investment vehicles such as mutual funds, discussing the merits of any security of type of security with a customer or handling any question that might require familiarity with the securities industry or the exercise of judgment regarding securities and investment alternatives. Unregistered employees will refer all securities-related questions to registered representatives of CSC. All telephone inquiries related to CSC will be answered solely by registered representatives of CSC. Unregistered employees will be prohibited from accepting or transmitting orders, handling customer funds or securities (except that unregistered employees may effect electronic funds transfers to CSC from an account at the Financial

Institution or required service corporation at a customer's request) or having any involvement in securities transactions other than providing clerical and ministerial assistance.

Unregistered employees of the Financial Institutions (including required service corporations) will not receive any compensation based on transactions in securities or the provision of securities advice. Unregistered employees may, however, be paid a nominal fee for referring Financial Institution customers to CSC. The amount of any such fees, which will be unrelated to the volume of securities traded by the customer, will be determined and paid by the Financial Institution (or required service corporation). Unregistered employees will be paid no more than one fee per customer referred. Other than this one-time, nominal fee, unregistered employees will not receive any other compensation, such as trips, free meals, or monetary awards, as the result of a referral or the number of referrals made. Supervisory employees will not receive any fees for referrals made by their subordinates.

CSC will provide conduct manuals to unregistered employees of the Financial Institutions (and required service corporations) that specify the limits on their permissible activities, as set forth above. Each Financial Institution (including required service corporations) will monitor the activities of its unregistered employees, and ensure their compliance with the limits on their permissible activities as set forth in the conduct manual. Furthermore, CSC will conduct periodic reviews to assume that the Financial Institutions (including required service corporations) and their unregistered employees comply with the limits on their activities set forth in the conduct manual. CSC also will provide each of its registered representatives with a copy of CSC's compliance manual. Registered representatives will adhere to the policies and procedures contained in CSC's compliance manual. CSC will monitor its registered representatives' compliance in this regard.

All brokerage services provided at the Financial Institutions (including required service corporations) will be provided by registered representatives of CSC, either Dual Employees or otherwise, all of whom will be registered and qualified as necessary with the Commission, the NASD, and any appropriate state regulatory authorities, and all of whom will be associated persons of CSC within the meaning of Section 3(a)(18) of the Exchange Act. Each Financial Institution (including required service corporations) will agree that any Dual Employee whom the Commission, the NASD, or CSC bars or suspends from association with CSC or any other broker-dealer will be terminated or suspended, accordingly, from all securities activities by the Financial Institution (and its required service corporation). The securities activities of each Dual Employee will be supervised by the supervisory personnel of CSC, who are registered securities principals. The amount of any transaction-related compensation paid to CSC's registered representatives, including Dual Employees, under the networking arrangement, will be determined solely by CSC. For convenience with respect to tax and social security withholding, health, retirement, and other benefits, transaction-related compensation may be paid to Dual Employees by the employer Financial Institution (including required service corporations), provided that it is clear that such payments are made on behalf of CSC from funds allocated by CSC for payment of Dual Employees.

Registered representatives are required to inform all securities customers, and obtain a written acknowledgment from such customers, that the brokerage services are being provided by CSC and not by the Financial Institution (or its required service corporation), and that the offered securities are not guaranteed by the Financial Institution (or its service corporation) or insured by the Federal Deposit Insurance Corporation ("FDIC") or any other federal or state deposit guarantee fund relating to financial institutions.

CSC will not solicit customers of a Financial Institution in connection with the purchase or sale of the securities of that institution or any of its affiliates (including required service corporations). CSC may execute unsolicited transactions in the equity securities of the Financial Institution or its affiliates (including required service corporations) on behalf of a Financial Institution customer, provided that the customer signs an affidavit affirming that the transaction was effected on an unsolicited basis and that the customer has been informed that the securities are not insured by the Financial Institution or any of its affiliates (including required service corporations), the FDIC or any other state or federal deposit guarantee fund relating to financial institutions. No debt securities of the Financial Institution or its affiliates (including its required service corporations) will be sold, on an unsolicited basis or otherwise, on any part of the premises of the Financial Institution that is generally accessible to the public.

CSC will pay a fee to the Financial Institution (including required service corporations) based on all securities transactions that occur at or are attributable to activities conducted on that Financial Institution's premises. CSC will provide a copy of this letter to each Financial Institution (including required service corporations) and will ensure that each Financial Institution (including required service corporations) understands its obligations under the networking arrangement.

Response:

On the basis of your representations and the facts presented, and strict adherence thereto by CSC, the Financial Institutions (including required service corporations) and their unregistered employees, and particularly in view of the fact that CSC is a registered broker-dealer and all personnel engaged in securities activities under the networking arrangements will be fully subject to the regulatory requirements of the federal securities laws and the applicable rules of SROs, the staff would not recommend enforcement action to the Commission under Section 15(a)(1) of the Exchange Act if CSC offers brokerage services under the networking arrangements described above without the Financial Institutions (including required service corporations) and their unregistered employees registering as broker-dealers under Section 15(b) of the Exchange Act. This staff position is based in part on CSC's representation that it will control, properly supervise, and be responsible for all registered representatives participating in the networking arrangements. Consequently, any designation of such registered representatives as "independent contractors" will have not effect on CSC's responsibilities under the federal securities laws, including without limitation Sections 15(b) and 20(a) of the Exchange Act.¹

This position concerns enforcement action only and does not represent a legal conclusion regarding the applicability of the statutory or regulatory provisions of the federal securities laws. Moreover, this position is based solely on the representatives that you have made; any different facts or conditions may require a different response.

Sincerely,

/s/ Catherine McGuire
Chief Counsel

¹ See *Hollinger v. Titan Capital Corp.*, 914 F. 2d 1564, 1572-78 (9th Cir. 1990), cert. denied, 111 S. Ct. 1621 (1991)

Questions and Answers about Nondeposit Investment Products

Scope

Q. Does the Interagency Statement (TB 23-2) apply to the retail sale of repurchase agreements?

A. Yes, the guidelines apply to the retail sale of all nondeposit investments, including repurchase agreements, to thrift customers. Nothing in the guidelines would apply to non-retail sales, such as institutional sales.

Q. If an institution offers discount brokerage services, do the guidelines apply?

A. The guidelines apply to the thrift's ¹ discount brokerage services; however, certain provisions such as suitability determinations may not apply if no investment advice is given or recommendations are made.

Q. If the thrift directs retail sales of nondeposit investment obligations through its trust department, do the guidelines apply?

A. Possibly. That determination is made on a case-by-case basis. The guidelines do not apply to fiduciary activities and the exception was designed to cover traditional trust activities. However, some thrifts may direct their retail sales of nondeposit products through the trust department. Therefore, the guidelines would apply to individual accounts administered in an agency capacity by the thrift which were set up solely to facilitate the purchase of nondeposit investment products. In addition, sales made through the trust department that are directed by the customer, such as self-directed IRAs or asset allocation accounts, are also considered "retail" and are covered under the Interagency Statement.

Oversight

Q. Should the broker/dealer Compliance Officer report to the broker/dealer Principal and not the thrift's board of directors?

A. Under the National Association of Securities Dealer's (NASD) guidelines, the compliance officer must report to the Registered Principal. However, it is very important that the affiliated broker/dealer's and the thrift's Board of Directors are fully informed of compliance issues affecting the nondeposit investment sales program within thrift offices. Both boards should receive regular compliance reports, descriptions of significant complaints, etc. The thrift's internal audit department should review the nondeposit investment sales project for compliance with the Interagency Statement.

Q. If the thrift has officers that are directors of the broker/dealer does the thrift's board have to also be involved in oversight/approval activities?

A. Yes. The thrift board has the ultimate responsibility to set policy for the nondeposit investment sales program and oversee it to ensure management is following such policy. While the common officers/directors are helpful in keeping affiliated organizations informed about each others activities,

¹ Throughout this document, "thrift" means thrift or service corporation, as appropriate.

formal oversight/reporting should be in place to ensure that the thrift board can fulfill its oversight responsibilities.

Q. The thrift provides registered representatives² with full access to thrift customer information for purpose of soliciting sales, any problem?

A. The sharing of customer information is governed by state law and thrift policy. The thrift should be able to demonstrate that it is in compliance with state law in this area. Many thrifts require the customer to authorize such access by any outside parties, and to preserve customer financial confidentiality, or may choose to give certain information, such as name and address, but not other information, such as account balances, CD maturity date or customer age.

Q. Is it adequate if only the broker/dealer's management evaluates mutual fund companies annually to ensure they are of acceptable quality before keeping them on the approved product list?

A. No. Thrift management should not rely on the broker/dealer to decide which product/product types are offered for sale within a thrift's office. The thrift should have sufficient oversight over the nondeposit investment sales program to ensure that the thrift is not exposed to undue risk and customer confusion is minimized. As such, the thrift should review the evaluation process and criteria the broker/dealer uses to ensure products are the type that the thrift wants its customers exposed to and its offices associated with. However, broker/dealers are responsible for knowing on a daily basis the attributes of all mutual funds they recommend.

Q. Is reliance on A M Best rating sufficient for an evaluation of annuity products?

A. No. A documented review of the user of the annuity products that are sold in thrift offices should generally include a review of financial performance and current information about the company, which include information provided by rating services such as A M Best.

Q. May registered representatives offer products beyond those approved?

A. It depends on the thrift's policy. Most thrifts restrict registered representatives to an approved product list to ensure that riskier products are not sold from with their branches. Other thrifts permit "unsolicited" orders for products not on the approved product list. Allowing a registered representative to sell any product he/she determines is suitable exposes the thrift to increased risk and should be discouraged if not accompanied with enhanced safeguards.

Q. Is it required that a thrift keep a log of oral complaints and written complaints?

A. The NASD requires each broker/dealer to keep a written log of all written customer complaints. Thrift should be encouraged to track oral complaints and periodically review the broker/dealer's complaint file and the actions taken to address the complaint. Doing so may help identify training,

² Throughout this document, the term "licensed registered representative" or "registered representative" is used for the sake of clarity and simplification. However, NASD registered representatives are limited to sales of securities (limitations vary by NASD designation). NASD registered representatives cannot sell fixed-rate annuities (an insurance product) unless authorized under separate licensing arrangements established by state law. For purposes of this document, registered representative will refer to both *NASD registered representatives* and appropriately *licensed state insurance sales representatives*, unless otherwise indicated.

procedural, and disclosure weaknesses. In addition, this review aids management in identifying unsuitable sales practices.

Personnel

- Q. May non-registered thrift employees tell a customer about the features and benefits of an institution's annuity and security products when making referrals?**
- A. No. Only appropriately licensed registered representatives should discuss the merits of nondeposit investment products. Thrift employees can, however, make referrals to registered representatives. A thrift employee that tells a customer about the benefits or features of a nondeposit investment product is providing investment advice which is prohibited. In no case should any non-registered person or any registered person while located in the routine deposit taking area, such as a teller window, make general or specific investment recommendations regarding nondeposit investment products, qualify a customer as eligible to purchase such products, or accept orders for such products, even if unsolicited.
- Q. May non-registered thrift employees provide a customer with a prospectus on the nondeposit investment product when making a customer referral to ensure that the customer has a written disclosure of relevant information about the product or when a registered representative is unavailable or out of the office?**
- A. No. Only Registered Representatives should provide a prospectus. Other product literature may be provided in making the referral, but extreme care should be exercised to avoid a nonregistered thrift employee from providing investment advice or fostering a perception that the products are thrift products, recommended by the thrift, or FDIC insured.
- Q. Is it permissible for a third-party non-affiliated broker/dealer to contract with thrift employees to become Registered representative for the broker/dealer during certain times.**
- A. Yes, such registered representatives become dual employees. To become NASD registered representatives, they must be sponsored by a registered broker/dealer (in this case, the non-affiliated, third-party broker/dealer), but they may also be thrift employees and paid by the thrift for that portion of the time they work for the thrift.

Advertising

- Q. May a radio advertisement by a thrift for nondeposit investment products be aired without all the required disclosures?**
- A. It is not practical to make all or, in some cases any of the disclosures on certain types of advertising. The federal banking and thrift regulatory agencies issued joint interpretations of the Interagency Statement on September 12, 1995. These joint interpretations clarify the Interagency Statement, and provide a disclosure alternative. OTS issued the Joint Interpretations of the Interagency Statement as Thrift Bulletin 23-3. In all cases, the advertisement should be clear as to the nature of the products offered and the broker/dealer making the sale.

Q. May nondeposit investment product literature be displayed anywhere in the branch?

- A. No. Nondeposit investment product literature should generally be located in the separate nondeposit sales area. It is acceptable to have such sales brochures/advertisements at the entrance and exit to the branch or sales area. Nondeposit investment product literature should not be placed next to teller stations or where new deposit accounts are opened as such literature may contribute to potential customer confusion. In addition, nondeposit investment products should not be advertised on the same rate boards for deposit accounts.

Q. May nondeposit investment product literature be located on ATMs?

- A. Yes. ATMs are not considered “routine deposit-taking areas.” An ATM is simply a communication device that facilitates many different kinds of transactions. Such literature of course, must contain the disclosures required in the Interagency Statement (RB 23-2).

Q. If the NASD clears an advertisement of the broker/dealer, may the thrift consider such advertisement acceptable?

- A. No. The NASD review will concentrate on all applicable securities regulations. The thrift should not assume that the advertisement complies with all requirements of the Interagency Statements.

Suitability**Q. Which of the following is necessary to ensure suitability?**

- a. Knowledge of the customer’s tax status.
 - b. Knowledge of the customer’s financial position.
 - c. Knowledge of the customer’s risk tolerance.
 - d. Knowledge of the customer’s time horizon for investing.
 - e. Knowledge of the customer’s investment goals.
 - f. Knowledge of the customer’s age, health, personal obligations.
- A. All of the above are key factors that should be considered in determining whether any recommend nondeposit investment is suitable for a particular customer. The registered representative should document all suitability information, which is generally contained on the initial application form.

Q. Is the registered representative required to describe a product to a customer, even though the customer has requested the product, to make sure the customer is aware of what he/ she is buying?

- A. Suitability determinations are necessary only when the thrift is offering investment advice. The scenario described is an unsolicited sale. If the customer specifically requests a particular investment product, the thrift may sell that product without elaboration based on that customer’s request. However, it is always a prudent sales procedure for a sales person to make sure the customer understands what kind of product he or she is buying and a suitability determination would be necessary if the registered representative believes the customer does not understand.

Disclosure

- Q. The disclosure says the investment “involves investment risk” and that the “investment can fluctuate in value.” In addition, it discloses that the investment is not FDIC insured, not an obligation of, or guaranteed by the thrift, and is not a deposit. Is this disclosure sufficient even though it does not say “involves investment risk including the possible loss of principal”?**
- A. The disclosures contained in the guidelines are the minimum information to be given. Disclosures that contain other information are acceptable, as long as that information does not distract from the core disclosures. Wording of the disclosures may vary in order to more accurately reflect a particular product, so long as the basic intent of the disclosures is not changed.
- Q. Do the same disclosures have to be made in an oral presentation as in the written customer acknowledgment/disclosure?**
- A. Generally yes. The required minimum disclosures must be provided orally during any sales presentation, orally when investment advice is provided, and orally and in writing prior to or at time an investment account is opened to purchase nondeposit investment products. The additional disclosures (advisory relationships, fees, penalties, etc.) may be made in writing (providing a prospectus containing such information to the customer for example) prior to or at the same time an investment account is opened to purchase such products.
- Q. Does a registered representative have to disclose that certain products are proprietary?**
- A. Yes. All advisory or other material relationships between the thrift or an affiliate of the thrift and an investment company whose shares are sold by the thrift and any material relationship between the institution and an affiliate involved in providing nondeposit investment products must be disclosed. Such disclosure may be in the prospectus.
- Q. Do the required minimum disclosures have to be on the front cover or the top of any text advertising brochure?**
- A. Generally yes. The required minimum disclosures may also be highlighted or contained within a box on the front cover or in a prominent location next to the first discussion of nondeposit investment products. The disclosures, no matter how highlighted or boxed, do not meet the conspicuous standard of the Interagency Statement if they are located on the back page of the sales brochure or advertisement and should be in type at least as large as the predominant type.
- Q. Does a registered representative have to disclose that they receive more commission for selling certain nondeposit investment products (e.g., receive more for selling an annuity than a mutual fund)?**
- A. No. However, all sales must be suitable and advisory relationships must be disclosed.
- Q. Does a registered representative have to disclose fees, penalties and surrender charges?**
- A. Yes. The Interagency Statement requires that fees, penalties and surrender charges be disclosed prior to or at the time an investment account is opened. This disclosure may be provided in the prospectus.

- Q. The prospectus contains an application that does not include the thrift's standard disclosures since it is a generic product put out by the mutual fund company. The thrift opens new accounts in its offices with an application that contains appropriate suitability and disclosure information. Any potential concern?**
- A. Yes. A problem exists if the application in the prospectus could be used to open a new nondeposit investment product account in the thrift's offices or when the thrift refers the customer. Nondeposit investment product sales within a thrift or as a result of a referral of retail customers by the institution when the institution receives a benefit for the referral must comply with the Interagency Statement. However, if the generic application in the prospectus is used only to open accounts via mail directly with the broker/dealer or mutual fund, the disclosures required by the Interagency Statement are not required.
- Q. The thrift uses a combined savings/checking and nondeposit investment product statement that presents the customers deposit and nondeposit account activity. Any potential concern?**
- A. Yes. Although combined statements may be used, if a customer's periodic deposit account statement includes account information concerning the customer's nondeposit investment products, the information concerning these products should be clearly separate from the information concerning the deposit account, and should be introduced with the required minimum disclosures and the identity of the entity conducting the nondeposit transaction.

Annuities

- Q. May fixed rate annuity sales be made from a new deposit account desk?**
- A. No. Fixed rate annuities are nondeposit investment products for purposes of the Interagency Statement and a new deposit account desk is considered a "place where deposits are routinely taken." Nondeposit investment products should not be sold from locations within the thrift where deposits are routinely taken.
- Q. May a NASD Series 6 Registered Representative sell fixed rate annuities?**
- A. Yes, provided that a separate insurance license is held if required by state law. Fixed rate annuities are insurance products for NASD and state insurance licensing purposes.
- Q. May literature use phrases such as "guaranteed" and "insured" in reference to an annuity product?**
- A. No, not in isolation. The use of such phrases in an insured institution could potentially confuse thrift customers. Any reference to a guarantee or insurance feature that does not also provide, in the same or the following sentence, the identity of the entity that provides the guarantee or insurance, is misleading. Such references should also disclose the aspect of the investment that is "guaranteed."
- Q. May documents relating to annuity products use language customarily associated with insured deposits or that refer to annuities as similar to deposits?**

- A. No. The use of such language in thrift sales program could potentially confuse customers.

Referral Fees**Q. May the broker/dealer pay a referral fee of \$20? \$50? \$100?**

- A. The referral fee should be nominal in amount, one time, and not dependent on a sale being made. Most institutions tend to pay from \$1 to \$10. A \$20 fee would be near the top end of “nominal.” The NASD currently has a proposal out for comment to their members that would prohibit a broker/dealer from paying referral fees. However, the proposal would not prohibit payment of referral fees by the savings association.

Q. May the thrift pay the registered representative more for selling proprietary products such as an affiliated mutual fund?

- A. Yes, and such additional payment for selling one’s own products is common. The compensation, however, cannot be structured to encourage or result in unsuitable recommendations/sales. The existence of a higher pay scale for proprietary funds warrants a more thorough review of suitability determinations.

Q. In order to receive a one time, nominal referral fee, the thrift employee must qualify the customer by making sure they have at least \$5,000 to invest and intend to make an investment within the next 30 days. Any problem?

- A. No, so long as the employee is not making general or specific investment advice/recommendations, accepting orders for such nondeposit investment products, or qualifying a customer as eligible to purchase such products (determining suitability).

Securities Investor Protection Corporation (SIPC) Insurance**Q. Does SIPC insurance protect investors from a decline in the market value of securities and the physical loss of securities if the broker/dealer holding the securities for the customer**

- A. No. SIPC does not protect investors from declines in value such as those that may result from changes in market conditions. SIPC protects investors’ securities or funds if the brokerage firm fails.

Q. May a SIPC sticker be placed next to a FDIC sticker at the thrift?

- A. The SIPC sticker should, as required by the NASD, be placed at the separate location within a thrift where nondeposit investment product sales are made. It should not be placed on a teller window, or on the door next to a FDIC insurance sticker. SIPC insurance should be explained and disclosed as not being similar or equivalent to FDIC insurance if it is mentioned in brochures.

Q. If SIPC insurance is mentioned what other information should be given?

- A. Incomplete or potentially confusing references to SIPC insurance is a problem. A complete explanation regarding the nature and extent of SIPC coverage should be given to customers. The following is a good example of disclosure relating to SIPC insurance: Accounts are protected by the Securities In-

vestor Protection Corporation (SIPC) which protects investor's securities or funds if the brokerage firm fails. SIPC insurance does not protect your account against declines in value such as those that may result from changes in market conditions.

Affiliates

- Q. An affiliated broker/dealer pays the thrift market rates for the space it occupies in each thrift office, any FRB 23B problem?**
- A. While the 23B test of "terms equivalent to those available to non-affiliated parties" is at first glance met by paying a market rent for the space occupied, it does not compensate the thrift for access to its customer base and/or customer information. Additional compensation is therefore required in addition to market rent per square foot. No standards apparently exist within the industry for this compensation. Non-affiliated, third-party broker/dealers generally pay a percentage of total commission generated from sales within thrift offices (40 percent to 90 percent) instead of a fixed rent per square foot for the right to sell nondeposit investment products within thrift offices. The difference in percentages paid reflects the differing levels of assistance provided by the broker/dealer such as whether the broker/dealer pays the Registered Representatives. The compensation of access to customers may be in the form of percentage of commissions earned or a fixed amount. The institution should be required to demonstrate that the payment meets the 23B test.
- Q. When the broker/dealer is a holding company subsidiary selling nondeposit investment products in the thrift, does the thrift need a written agreement on such sales? Written lease for space?**
- A. Yes to both questions. The affiliated broker/dealer is considered a third party for purposes of the Interagency Statement. Written third-party agreement and leases should meet all regulatory requirements -including the requirements within the Interagency Statement and the OTS legal opinion dated February 7, 1985.
- Q. May a Series 7 registered representative of an affiliate broker/dealer located within a thrift accept unsolicited orders for the thrift holding company stock and bonds?**
- A. Yes. Generally, such sales are not permitted pursuant to 12 C.F.R. 563.76. The only written exceptions are the sale of conversion stock and the exceptions listed in TB 23a which include unsolicited matching buy and sell orders of thinly traded stock, however, unsolicited orders may be filled as a customer courtesy.

CHAPTER: Other Activities

SECTION: Insurance

Section 720

INTRODUCTION

As discussed in Handbook Section 730, Related Organizations, related organizations can significantly affect the operations and overall financial condition of the parent thrift. The purpose of examining these entities is to determine the extent to which they pose a risk to the parent thrift. This Section is devoted to evaluating the risks associated with insurance activities conducted by a thrift's service corporation subsidiary.

Federal thrifts may establish or acquire a service corporation to conduct insurance activities in accordance with 12 CFR § 545.74(c), but are otherwise generally prohibited from directly engaging in the business of insurance. A service corporation's insurance operations can provide a parent thrift with the potential to increase consolidated earnings, cross sell services, and diversify its investments. Along with such benefits, insurance activities can also present substantial risk to the parent thrift.

Throughout this Section, various aspects of insurance operations are highlighted as potential areas of risk that should be addressed by service corporation management through internal procedures and policies. The successful implementation of internal controls is essential for containing risk, maintaining profitability and ensuring compliance with applicable state and federal laws. The extent to which service corporations comply with statutory and regulatory requirements can materially affect a related organization's viability, the thrift's exposure to loss, and the public's overall perception of the parent thrift.

The states have the power to regulate as well as tax the business of insurance. The McCarron-Ferguson Act, 15 USC §§ 1011-1015, precludes the application of federal law where state law regulates the business of insurance and to the extent that federal law would invalidate, impair or supersede state law. This decentralization of insurance rules and regulations makes it impractical to describe the distinctions between states in their approaches to regulating insurance. Service corpo-

ration management must implement measures to ensure compliance with federal laws pertaining to thrift subsidiaries and state laws applicable to insurance activities.

In determining the level of risk presented to the parent thrift, the regulator must obtain an adequate understanding of the service corporation's activities and operations as discussed in Handbook Section 730. This section supplements Handbook Section 730 to provide regulators with an overview of insurance concepts and activities and guidance on how to identify and evaluate risk inherent in a service corporation's insurance operations. Specifically, this Section provides an overview of the following areas.

Permissible Insurance Activities and Related OTS Requirements

The OTS rules and regulations limit the types of insurance activities that federal thrifts may conduct through service corporation subsidiaries absent prior OTS approval. These restrictions and other applicable regulatory requirements (i.e., maintenance of separate corporate identities, conflicts of interest) serve to minimize the risk presented to the parent thrift and are detailed in the Overview Section. Certain of these standards are highlighted in this Section's discussion of the insurance subsidiary review. Thrift Bulletin (TB) 23-2, Interagency Statement on Retail Sales of Nondeposit Investment Products, also applies to sales of variable annuities and insurance products that have investment features, but not to pure insurance products such as credit life or term life insurance. TB 23-2 identifies safeguards that service corporation and thrift management should implement to address specific risks associated with sales of investment products on a thrift's premises or as a result of thrift customer referrals.

Types of Insurance Activities

The types of insurance activities typically conducted through service corporations (agency,

brokerage, underwriting, reinsurance, and premium financing) are described along with suggested areas of review to determine the level of risk presented to the parent thrift. A discussion of “third party” arrangements is also provided. Service corporations may use third parties to market, sell, underwrite or otherwise provide insurance products and services, but must monitor these arrangements in a prudent manner. While the regulator is not responsible for ensuring that activities comply with state laws and regulations, the adequacy of management’s internal controls in addressing potential areas of risk is an important aspect of the regulator’s review.

Insurance Products Sold Through Service Corporations

A summary of certain types of insurance coverages typically sold through a federal thrift’s service corporation is provided in the latter part of this Section. Insurance products must comply with the requirements of state insurance departments. Products such as variable annuities and variable life insurance must also comply with any applicable requirements of the Securities and Exchange Commission (SEC) and the National Association of Securities Dealers (NASD).

The discussion and examination procedures that follow should be incorporated in the regulator’s overall review in a manner consistent with the approach detailed in the Overview Section. Since the business of insurance is regulated at the state level, regulators should, in accordance with regional office policy, obtain examination reports and other relevant information maintained by state insurance departments. These records can be useful in identifying areas of risk during the examination scoping process.

PERMISSIBLE INSURANCE ACTIVITIES AND RELATED OTS REQUIREMENTS

For active related organizations, the examination scoping process involves determining whether the related organization complies with applicable regulations and related policies. The discussion that follows highlights certain regulations that generally apply to all service corporations and those that apply specifically to the conduct of insurance

activities. (Refer to Handbook Section 730 for a detailed discussion of service corporation requirements, estimating risk, and scope of review.)

Permissible Insurance Activities

Section 545.74(c) provides that service corporations may, in accordance with the notification requirements established in 12 CFR § 545.74(b)(2), engage in “preapproved” insurance agency and brokerage activities for a limited scope of coverages (i.e., automobile, life, health, accident, and title insurance). Service corporations, however, are generally prohibited from offering private mortgage insurance.

A thrift may apply to the OTS for special permission to conduct additional “reasonably related” insurance activities through its service corporation subsidiary.

Some examples of activities that the OTS has approved on a case-by-case basis are:

- Investing in equity securities of a holding company that owns a private mortgage insurance company;
- Underwriting mortgage life and credit life insurance on the lives of borrowers and savers of the parent thrift and its subsidiaries;
- Incorporating and operating a wholly-owned reinsurance company to reinsure mortgage life, mortgage disability, credit life, and credit disability insurance purchased by customers of the parent thrift, its subsidiaries or any affiliates (the term affiliate is defined in 12 CFR § 563.41);
- Forming a second tier service corporation to provide administrative and managerial services to a financial organization engaged in underwriting credit-related insurance; and
- Underwriting life insurance for customers where such coverage was not related to the extension of credit.

The foregoing activities are generally limited in scope and must conform to applicable operating requirements and restrictions including those set

forth in an OTS approval order. In determining whether service corporations of state-chartered thrifts may engage in similar activities, management should provide sufficient documentation confirming that such authority exists. Subsidiaries of state-chartered thrifts are generally limited to activities permissible for federal thrifts. (See Handbook Section 730 for more detail on subsidiaries of state-chartered thrifts.)

Generally, requests to engage in activities, not listed as preapproved, will be denied when applications are incomplete or it has not been adequately demonstrated that the activities are reasonably related to the activities of federal savings associations. To date, the OTS has not approved the following insurance-related activities:

- Issuing (underwriting) directors' and officers' liability insurance;
- Issuing (underwriting) private mortgage insurance;
- Reinsuring life and disability insurance that would be offered to employees of the parent thrift and its subsidiaries;
- Underwriting or reinsuring non-credit-related whole life, universal life and annuities for borrowers and account holders of the parent thrift and its subsidiaries; and
- Investing in the capital stock of a proposed life insurance company.

The regulator should verify that the service corporation has commenced its insurance activities in accordance with OTS application or notification requirements. These requirements vary based on whether the activity is preapproved pursuant to § 545.74(c) and whether the parent thrift is eligible for expedited treatment in accordance with § 516.3.

Maintaining Separate Corporate Identities

As detailed in the Overview Section, determining whether a thrift and its subsidiaries maintain separate corporate identities is an important aspect of the regulator's review. A separate corporate identity distinguishes the activities of the subsidiary

and the parent thrift in a visible and obvious manner and, therefore, protects the parent thrift from the debts and other liabilities of its subsidiary. Section 571.21 contains five guidelines that provide minimum standards for the maintenance of separate corporate identities. A clear violation of § 571.21, for example, would occur if there is evidence that insurance is being sold by the thrift itself in connection with closing a loan, with no effort being made to explain to the customer that the insurance is being provided through a separate subsidiary.

A review of stationery and logos, and whether there is physical separation between the service corporation and its parent thrift will alert the regulator as to whether separate corporate identities are maintained. The following questions should be considered:

- Is it obvious to the casual observer that the insurance subsidiary, operating on the parent thrift's premises, is a separate corporate entity?
- Is there physical separation between the personnel offices, and desks of the parent thrift and the service corporation?
- Is a separate telephone number listed in the directory?
- Do signs and literature clearly indicate that products are sold by the service corporation and not the thrift?
- Do advertisements, literature, and other disclosures conspicuously state that the insurance/investment product is not FDIC-insured?

A review of internal controls and any agreements with the parent thrift or a third party may assist in determining whether separate corporate identities are maintained by subsidiaries. Thorough internal procedures may serve to prevent conditions that could give rise to a court finding that separate corporate identities have not been maintained.

Tie-in Prohibitions

A parent thrift is prohibited from requiring customers to purchase products or services from its

service corporation. For example, a thrift requiring credit life insurance on a specific loan must make clear to the customer that there is an option to purchase either the coverage offered by the service corporation, or similar coverage from elsewhere. Section 563.35 does not preclude a thrift or its subsidiary from refusing to make a loan if, based on reasonable grounds, its findings indicate that the insurance coverage obtained by the borrower is inadequate. [Note: In certain states it is not legal to require credit life insurance.]

Control Over Placing of Hazard Insurance

In 12 CFR § 556.4, the OTS addresses the borrower's right to select a hazard insurer, as long as the coverage meets the reasonable requirements imposed by the parent thrift. The thrift must not permit standards for insurance coverage to be tailored to the products offered by a given service corporation, or limited to companies it represents.

Guidance on the Sale of Investment Products

TB 23-2, Interagency Statement on Retail Sales of Nondeposit Investment Products, applies to sales of investment products (i.e., variable-rate, annuities, insurance products that have investment features, mutual funds) on the parent thrift's premises or as a result of customer referrals. TB 23-2 does not apply to the sale of pure insurance products such as term life insurance. The OTS's examination authority covers all sales of investment products on thrift premises, including those offered by service corporations, affiliates and third parties. Specifically, the guidance addresses:

Safeguards to prevent customer confusion. Sales of investment products in the offices of thrifts present a special risk that customers may confuse investment products with FDIC-insured deposits. The service corporation's internal controls should ensure that its activities are clearly distinguished from the parent thrift's operations.

Sales techniques and disclosures. Sales techniques and disclosures in advertising should not mislead customers regarding the characteristics of the investment products and should clearly identify the service corporation or a third party (not the parent thrift) as the seller. For example, the service corpo-

ration's use of the parent thrift's logo in its sales literature could lead customers to believe that the thrift is offering insurance services. Additionally, sales of investment products such as variable annuities should include sufficient disclosures indicating that, for example, the product's value may fluctuate.

Compensation. The service corporation's files should contain information on the responsibilities of employees that are authorized to sell investment products and other personnel that interact with customers. Compensation structures for each class of personnel should be documented and available for review by the regulator. Any customer referral fees paid by the service corporation to thrift employees should be nominal and should not be dependent upon a sale of an investment product. [Note: The payment of referral fees should comply with applicable state law and securities rules and regulations.]

Sales training. The parent thrift and service corporation should ensure that personnel selling investment products are adequately trained. The training should be designed to prevent the misstatement of material facts, the use of overly optimistic or deceptive forecasts, the making of unsuitable recommendations, and the dissemination of any other information that is false or misleading. Also, management should ensure that sales representatives comply with any applicable licensing or registration requirements.

In summary, the service corporation's internal policies and procedures should serve to ensure that sales of investment products on the thrift's premises are performed in a prudent manner and in accordance with safe and sound operating procedures. Adequate records pertaining to all sales should be maintained in a manner that facilitates a prompt review by management and regulators. In addition, any agreements with third parties or the parent thrift (i.e., for leasing office space) should be approved by the service corporation's board of directors and be consistent with established internal policies and sound business strategies. The roles of any dual employees (employed by both the parent thrift and service corporation or a third party) should be documented along with the method of compensation. The service corporation's management should be required to explain any ma-

terial variances from established policy and the potential effect of such actions on the parent thrift. (For a detailed discussion of TB 23-2 and related guidance, see “Policy on Sales of Investment Products and Referral Activity” in Handbook Section 710, Nondeposit Investment Sales.)

Usurpation of Corporate Opportunity

Section 556.16 states that federal thrifts are prohibited from referring insurance business to a service corporation insurance agency under certain circumstances. When a thrift is making every possible attempt to obtain state approval to establish a service corporation as a provider of insurance, insurance business may be referred by thrift employees to an agency that is temporarily owned by the parent thrift’s officers or directors. The intent is to allow such activity only when the situation is not permanent. This is an effort to ensure that officers and directors do not usurp corporate opportunity. (Refer to “Conflict of Interest Considerations,” Handbook Section 730.)

TYPES OF INSURANCE ACTIVITIES IN SERVICE CORPORATIONS

In addition to ensuring compliance with regulatory requirements, policies and application approval standards, service corporation management must conduct insurance activities in a safe and sound manner. An effective system of internal controls ensures the integrity of operations and attempts to limit fraud or manipulation of an organization’s records. Internal controls should also adequately address the monitoring of services performed by third parties.

Service corporations may rely on third parties to market, sell, underwrite or otherwise provide insurance products. These arrangements can provide service corporation management with expertise and services that otherwise would have to be developed in-house or purchased. Third parties that establish joint ventures with service corporations range from marketing organizations to brokerage houses, consulting groups, and insurance companies. The range of products and services they offer is very broad, and can be tailored to the specific needs of the service corporation. A third party can, for example, provide or develop a wide array of life and

property/casualty insurance products for a service corporation. A third party may consider the service corporation to be a conduit to sales, or may offer administrative and managerial services on a fee basis. Services provided by a third party may include:

- Training existing personnel, or recruiting and placing its own employees in a service corporation;
- Offering data processing, sales management, billing and accounts receivable or other services; or
- Managing the entire operation.

There are numerous types of arrangements involving third parties and service corporations. While service corporations can realize certain benefits from these arrangements, the regulator should be familiar with, among other concerns, the following risks:

The risk that the venture will fail. This risk can be minimized with appropriate market studies and with an objective evaluation of the third party.

Noncompliance with statutory and regulatory requirements. The service corporation should initially and periodically review the record of regulatory violations by third parties and any of their employees.

Improper representations and disclosures. Improper representations and disclosures by a third party may lead customers to misunderstand the actual nature of the product or service. This can result in a belief that the thrift has been a party to a sale made under pressure or through misrepresentation. Thus, the risk is that customers are often not sufficiently sophisticated in matters concerning insurance and investments to recognize, for example, that the interest rate on a fixed-rate annuity is not competitive.

Misleading advertisements. Advertisements, for example, should not refer to annuities as “Certificates of Deposit (CDs) offered by an insurance company.” These investments, unlike traditional CDs, are not insured by the FDIC or any other government agency, and should not be represented

as being so. Some organizations have signs and use forms to ensure that the customer does not make that assumption. (Refer to the discussion of “Guidance on the Sale of Investment Products” in this Section.)

Third party arrangements should be documented in a written agreement between the service corporation (not the parent thrift) and the third party providing the services. Regulators should review these agreements and the service corporation’s systems to ensure that third parties comply with contractual provisions and safe and sound practices.

Insurance activities, whether conducted directly by a related organization or as a joint venture with a third party, present certain safety and soundness concerns that can affect the parent thrift’s exposure to loss. The following section discusses the most common types of insurance activities, their related risks and regulatory concerns.

Agency Brokerage

An insurance agent represents one or more insurance companies, while a broker represents an individual or an organization seeking coverage. Despite this difference, many of their operations and associated risks are similar. The following discussion refers primarily to agents, but also applies to brokerage operations.

Insurance agents are regulated by state or territory insurance departments. These departments administer qualifying exams to prospective agents, issue licenses, and suspend or revoke the licenses in the event of violation of the state insurance code. State insurance departments also conduct hearings regarding various forms of misconduct, and regulate the business of the agency, sometimes through examinations or audits. The state insurance department is a source that the regulator may consult when reviewing a service corporation’s insurance activities.

While a review of state examination reports can be helpful in identifying areas of risk during the pre-examination analysis, the regulator should, nevertheless, conduct the appropriate level of review for evaluating the effect of agency and brokerage activities on the parent thrift. A review of the

following aspects of these activities can reveal potential operating weaknesses:

Trust account balances. Perhaps the most important element of examining an insurance subsidiary is a review of trust account balances. Regulators should be able to verify that all monies owed to the insurer or insureds are identified in the trust account, and that the account is in balance. Procedures for deposit and payout should be reviewed to determine if they are appropriate. The regulator should also analyze intercompany transactions for reasonableness and the basis upon which the producer (agent) is remunerated.

Liability to customers. This is a major area of concern in any agency relationship. An agent has an obligation to provide a customer with products that are best suited to his or her needs. In third party arrangements between a service corporation and an insurance provider, the contract may include a provision whereby the third party assumes such liability. This protects the service corporation as well as the parent thrift from the actions of the third party, and is desirable although not required. In addition to determining whether such contractual protection exists, the regulator may want to consider whether the service corporation carries fidelity insurance in amounts adequate to protect it from inappropriate actions of its employees. Such “errors and omissions” insurance is very desirable, but often not available.

Premium payment procedures. When insureds are not directly billed by the insurer, the insurer and the regulator must be alert to the dangers of the agent withholding premium payments for a period of time before forwarding them to the insurer. Inadequate audits and controls have allowed unscrupulous agents to make use of the payment funds for their own purposes, such as placing them in interest-bearing accounts. On occasion, however, an agent might obtain permission to hold insurer funds, and thereby legally earn interest on the “float.”

Inadequate controls. When a review of operations discloses inadequate controls, the regulator should determine the average age of accounts receivable, and whether there are adequate reserves for uncollectables and for charge offs. Problems in collections may be indicated by a high average age

of accounts receivable, and frequent carryovers in accounts payable may be an indication of poor management or funding problems.

Systems for managing the flow of premiums.

When the service corporation/insurance agency acts as a premium collector/remitter, the regulator should take every reasonable measure to ascertain that the agency's business is being conducted in a sound and legal manner. It would be appropriate to obtain copies of the insurer's financial statements and recent examination reports to evaluate overall viability and identify any deficiencies in underwriting and claims practices. Care should be taken so that such requests are not perceived as extraordinary measures that could jeopardize the goodwill between the agency and insurer.

The findings revealed in examination reports and records on file with state insurance departments can be helpful in identifying risk inherent in a subsidiary's insurance activities. Additionally, state insurance departments and insurers represented by the agency can provide information on consumer complaints against the agency, and whether there is any pending action that might affect profitability or the ability to continue insurance operations.

Adequacy of Records and Related Safety and Soundness Concerns.

The service corporation's management and board of directors should maintain adequate records and reports with respect to monitoring the entity's operations and performance. These records should include the following:

Financial statements. A review of the agency's operating statements for the last three years should reveal any material trends. For example, a continually decreasing commission income might be related to area demographics, to increased competition or other factors in the insurance environment, or to poor management.

Weak operating results require further analysis to identify the specific cause of this level of performance. Poor earnings can, for example, be attributable to overstaffing. Generally, each employee should generate sufficient premium volume for an agency to be viable as detailed in the service

corporation's business plan along with estimates pertaining to gross volume. Management should be able to explain substantial variances from projections and any deteriorating trends.

Insurer soundness. The insurers represented by the agency are indicators of soundness, and their stability and financial condition reflect the agency's stability and soundness. The regulator can consult Best's Ratings, which evaluates underwriting and management considerations, policyholder surplus, and other financial indicators of major insurance carriers. Another source of information is the National Association of Insurance Commissioners' (NAIC) Insurance Regulatory Information System (IRIS). The IRIS provides ratios relating to an insurer's operations. While it is true that state guaranty funds may partially or fully protect an agent from an insurer's insolvency (except for surplus lines), public knowledge of an agent's association with an insolvent insurer can lead to negative publicity and loss of business.

Representation. Service corporation insurance agencies usually represent more than one insurer. It is considered healthy for a small agency to represent a minimum of three insurers and for a medium-sized agency to represent from three to six insurers. Representing too few insurers does not allow the agent to offer alternatives. While representing too many insurers increases potential income, it does not allow the agency to represent all insurers effectively.

Customer base. The agency's management should analyze the composition of its customer base to identify significant changes. Major changes in the demographic makeup—age, sex, marital status, location—should be related to such factors as area demographic changes, changes in marketing strategy, and so forth. Similarly, renewal rates of policyholders from one year to another should be tracked to determine whether the customer base fluctuates in a manner that places the service corporation at risk of sudden loss of business and, therefore, loss of income.

Products. Material variances in the agency's product mix may represent a change in the corporation's strategic objectives or inadequate control over the agency's direction. A newer agency will typically limit its operations to estab-

lished personal lines such as automobile and homeowners coverages. More experienced and established agencies might become involved in commercial accounts. This might tie into the parent thrift's strategy to embark into commercial lending.

Account mix. Some agencies have a few very large accounts that comprise 5% or more of the total revenues. A large number of such accounts or a large proportion of premiums derived from these accounts is a source of concern since it leaves the agency vulnerable to rapid attrition.

Objectionable Practices

Certain acts by insurance agents are considered unethical, and in many states are illegal. The regulator should be alert to such practices. While state regulatory authorities are responsible for discovering and taking action regarding such activities, illegal or unethical behavior can result in an agency being subjected to heavy fines, adverse publicity and even being closed down. The following examples of objectionable practices could potentially subject the parent thrift to economic and legal liabilities:

Self-dealing. Controlled business in most states is limited by law or by regulation. It consists of business that an agent sells to oneself, or principally to friends and relatives.

Misrepresentation. Misrepresentation occurs when an agent makes statements that are untrue or misleading when describing insurance policy terms. The agent also should not misrepresent the applicant to the insurer.

Rebates and gifts. Rebating is the granting of any form of inducement, favor or advantage to the purchaser of insurance when that inducement is not made available to all purchasers. In some states this is a penal offense for both the agent and the person accepting the rebate, and the agent's license may be suspended or revoked. The agent also must not accept gifts as an inducement to provide insurance protection.

Twisting practices. Twisting occurs when an agent induces a policyholder to terminate a policy with one company and to take out a policy with another

company when it is not to the insured's benefit to do so. An agent has a responsibility, however, to advise a client to accept another policy if the terms of the new policy are appropriate and more favorable. Thus, insurance should not be sold on the basis of gain to the selling agency, but on the basis of best coverage at the best price with the best service and without regard to commission income.

Untimely and unfair claims distributions. Agents who have claims authority are required to abide by state fair claims practice statutes and regulations. These statutes generally require claims to be paid promptly (generally within a specified time period) and in accordance with the provisions of policy contracts.

Underwriting

A service corporation that underwrites insurance business is an insurance company. Underwriting involves balancing the quality of a prospective risk with the appropriate rate, terms and conditions. In most types of insurance, rates and surcharge/discount plans are developed by the actuaries, and underwriters apply them to the risks. Underwriters may also seek modification to the risk, such as with increased deductibles or lower limits of liability, in an effort to produce better-than-average loss ratios by requiring the insured to assume a greater part of the risk.

An integral part of underwriting involves monitoring the risk on an ongoing basis. This might involve a policy file review subsequent to losses of a certain magnitude, or an occasional review of various consumer reports, motor vehicle reports, and so forth. A deterioration of the risk may be grounds for cancellation in extreme cases, or non-renewal when the current policy term expires. Alternatively, the underwriter may choose to apply premium surcharges to a deteriorating risk.

Ownership of an insurer as well as the functions of underwriting are not preapproved service corporation activities. On a case-by-case basis, the OTS has deemed the underwriting function to be a "reasonably related" activity following a review of an application filed by the parent thrift. Therefore, the regulator must determine whether the OTS has authorized the activity in the form of an approval order.

Once established, insurance underwriting operations fall within the jurisdiction of state regulatory authorities. State insurance departments, however, may be unable to perform complete audits and examinations of every domestic insurance company due to resource limitations. Also, states typically do not take responsibility for examining foreign or alien insurers, unless a specific problem is being investigated. The distinctions between domestic, foreign and alien insurers are as follows:

- Domestic insurers are chartered by the state in which they do business;
- Foreign insurers are chartered by another state, but are licensed in the particular state to do business; and
- Alien insurers are chartered outside the United States.

The state responsible for regulating the insurer is the state in which it is chartered. Often, however, state regulators limit their inquiries to reviews of the pricing mechanism, and to the resolution of consumer complaints. Thus, while the OTS should obtain as much information as possible from state regulators, an independent review of the service corporation should be conducted to determine whether it poses any significant risks to the parent thrift. The regulator should also obtain a copy of the insurer's annual public audit.

Reviewing Underwriting Practices and Procedures

Some of the primary areas that are typically addressed in state examination reports are outlined below. Findings revealed through the review of these areas should be considered in evaluating the level of risk presented to the parent thrift.

Unfair trade practices. As mentioned above, insurers are expected to live up to professional and ethical standards, often promulgated by law or regulation. Violation of these standards can result in heavy fines as well as adverse publicity. The NAIC has a model Unfair Trade Practices Act that has been adopted in part or in whole by many states. The Act, for example, prohibits terminating coverage due solely to an insured's mental or physical impairment. All states generally require

that the insured be given written notice before a policy is canceled or non-renewed. State laws often specify the amount of time and the form of the notice, and even the class of mail to be used.

Among other issues, the Act considers it an unfair trade practice for an agent or other producer to rebate part of the sales commission to the applicant, and places severe restrictions on various types of discrimination. The concept of underwriting implies discrimination in the selection of insureds. Underwriting involves grouping people, businesses and properties into like classes. While it is important for an insurer to identify those likely to suffer losses and to charge a premium commensurate with the loss potential, an insurer must not discriminate unfairly.

Unfair discrimination involves applying different standards to people or groups who have the same potential for loss. The laws of most states specifically identify, define as unfair, and prohibit discrimination, on the basis of age, sex, marital status, occupation, physical impairment, location (this is called "redlining"), blindness, and other factors. The regulator may review a sampling of rejected applications to ensure that they are not refused on the basis of unfair discrimination.

While the insurer must not discriminate unfairly against applicants or insureds, the company has an obligation to its owners for adhering to its published guidelines with few exceptions. An insurer that is too liberal or non-selective in placing business on the books will eventually suffer excessive underwriting losses. Consequently, the regulator's review of state examination reports may indicate whether exceptions to underwriting guidelines are being made for valid reasons.

Unfair claims practices. Most states have adopted legislation or regulations prohibiting insurers from participating in unfair claims practices. Many of these are based on the NAIC's Model Fair Claims Practices Act that identifies certain activities an insurer should not participate in. The Act, which has been adopted at least in part by many states, requires insurers to acknowledge receipt of a claim within a specified number of days following a receipt of notification. It requires insurers to respond to a claimant within a reasonable time as to whether the claim is to be honored or denied. It

also considers it an unfair practice for an insurer to settle a claim for less than what “a reasonable man” would consider appropriate under the circumstances. An insurer, however, cannot afford to interpret insurance contracts too liberally such that the insured benefits beyond the loss experienced and covered under the policy.

Pricing. In pricing, it is also important that the insurer adhere to state laws. For example, a number of states have enacted “unisex” legislation such that insurers may not charge different rates for males and females. Furthermore, any surcharges, discounts, debits or credits should be applied in accordance with a state-approved rating structure. Rate filings with the state insurance authorities should be based on sound statistical evidence that clearly indicates the need for premium increases or decreases.

Financial condition. The financial condition of the insurer is of great interest to the regulator. The primary objective of audits conducted by state regulators is to determine the solvency of the insurer. The IRIS, maintained by the NAIC, monitors and identifies insurers that are in or approaching financial trouble. It computes ratios based on data from the insurers’ financial statements to assess operations (i.e., liquidity, solvency, profitability, reserve and surplus levels).

When reviewing financial records, the regulator should verify that funds are not being infused from the parent thrift or an affiliate to support an ailing insurance operation. Yet, such funds may be necessary to keep the operation viable so as to facilitate a sale.

Accounting issues. Insurers use the statutory accounting system, rather than Generally Accepted Accounting Principles (GAAP) for most purposes. For insurance companies, solvency is defined through Statutory Accounting Principles (SAP) rather than through GAAP. The statutory method is more conservative than GAAP in that its objective is to promote the solvency of insurers. Insurers view profitability or loss from two perspectives: (1) from underwriting operations (pure insurance) and (2) from investments. Insurers should not accept underwriting losses on the assumption that these losses can be more than compensated for through investment profits.

The interpretation of financial statements such as the Annual Statement, the Insurance Expense Exhibit in the Annual Statement and supporting documentation, requires a recognition of at least the major differences between GAAP and statutory accounting. Since SAP will vary among states, state insurance departments can be contacted for determining the differences between SAP and GAAP.

Reinsurance

As individuals and businesses purchase insurance to protect themselves from the consequences of loss, so do insurers. The product they purchase is reinsurance which, in effect, is the sharing of risk by the primary insurance company with other insurers. The company accepting the exposure is the reinsurer. Thus, reinsurance is insurance for insurers. Reinsurers are primary insurers, but there is no specific license that they must obtain.

Traditionally, reinsurance has not been regulated as strictly by the states as has primary insurance. One major reason for this is that often the customers of the primary insurer are less sophisticated with regard to insurance, and can be taken advantage of rather easily. Insurers, however, are better able to determine for themselves what their needs and risks are, and how to handle them.

As with primary insurance, laws regulating reinsurance vary widely between the states, particularly with regard to foreign or alien companies, as well as nonadmitted (not licensed) companies. In some states, reinsurance by nonadmitted companies is prohibited, while in others such arrangements are allowed, but restrictions are generally placed on reserves or operations.

Reinsurance as a business venture may be of interest to service corporations for the following reasons:

- Reinsurance offers a valuable service to primary insurers and a ready market for the product exists;
- As a consequence of a generally less restrictive regulatory environment, reinsurance offers service corporations a way of participating in underwriting activities without having to bear

the expense of purchasing or forming a primary insurance operation;

- The nature of the business is such that it can be entered on a limited basis and can grow as expertise in particular markets is developed; and
- A captive reinsurance company can be an organization formed solely to provide reinsurance services to a controlled group of organizations. As such, it allows the benefits of insurance company activities without the expenses associated with a complete insurance operation.

Reinsurance is not a preapproved activity under 12 CFR § 575.74(c). For a service corporation to engage in reinsurance operations, the parent thrift must apply to the OTS for prior approval. On a case-by-case basis, the OTS has approved reinsurance operations as reasonably related to the financial operations of thrifts. For example, a service corporation has been permitted to underwrite, as a reinsurer, life and disability insurance policies that are directly related to the extension of credit by the service corporation or the parent thrift. OTS approval orders, however, often establish operating restrictions and limit the business to certain insurance carriers.

In addition to the benefits described above, there are a number of potential risks that may be inherent in reinsurance operations. Since the reinsurer is further removed from the subject of insurance, losses can be difficult to determine or predict. An insurer will often reinsure a policy or a block of business knowing that the chance of substantial loss is high. Thus, the risk falls upon the reinsurer, who must be alert to the possibility of higher than average loss when determining acceptability and appropriate premiums. In technical areas, this requires the use of very specialized personnel on the part of the reinsurer.

Occasionally, reinsurance market transactions can become so complex that a primary reinsurer will not be aware that it is holding a portion of a given risk more than once, in several layers. This can be true in coverage for space satellites, for example, where a reinsurer may transfer a portion of a risk, and a portion of that same risk is transferred back in another package. A company making such transfers to a captive reinsurance company may not get

credit for reinsurance at the time of a loss, because the notification of a loss may not come for years after the loss occurs.

While the foregoing risks are real and must be considered, they affect primarily large reinsurance operations. Reinsurance is an international business and the complexity of reinsured risk on top of reinsured risk in the international marketplace can be staggering. Most reinsurance transactions that involve service corporations, however, are considerably simpler and narrower in scope than those in international markets.

Premium Financing

The premium financing business is a natural one for service corporations that are affiliated with an insurance agency or brokerage because of the synergy that exists between the two businesses. Premium financing allows persons who otherwise could not afford it to purchase insurance. This is accomplished by spreading premium payments over a longer period of time which allows the agent to sell more insurance. Premium financing is typically used in such lines as non-standard auto insurance, where premiums are high for young drivers or other persons with questionable driving records. Premium financing can also be used effectively with many other types of insurance. This does not suggest that the practice is without risk.

Premium financing is regulated at the state level by the insurance department or by the department of finance or commerce. While applicable laws and regulations vary among states, certain states may not have premium financing laws. A service corporation's interests as a premium financing lender would not be protected by statute or regulation in these states. In creating premium finance statutes, state legislatures usually attempt to meet the objective of a better insured public while protecting society from hazardous lending practices.

Financing of insurance policies must be approved rapidly because insurers require premiums to be paid at policy inception. This results in a system that does not require credit approval. Statutes allow the premium finance company to write the contract without prior credit approval because the ultimate user (the insurance company) must act in a prescribed manner if the insured defaults. In such

cases, the insurer must cancel the insurance policy and return unearned premiums to the finance company. The lender retains the unearned premium, the earned portion of the finance charge, a late charge and a cancellation charge. This protects the interests of the lender. [Note: Premium finance interest rates and related charges (i.e., late or cancellation) are generally controlled by the states.]

If a borrower gives a premium payment to an agent, the law of agency stipulates that the effect is as if the money had been given to the insurer. Should the agent disappear, the premium finance company is protected by law and must be indemnified (paid) by the insurer. This protection does not exist when the agency and premium finance company are jointly owned.

General Areas of Risk

Premium finance companies face numerous risks against which they must establish safeguards. Some of the major areas of potential risk include:

Fraud. This is a major area of risk and measures should be taken to guard against it. While fraud is often perpetrated by only one individual, such as the insurance agent, occasionally there is collusion with a borrower.

Agents may, under the law or otherwise, be authorized to sign the finance agreement on behalf of the borrower/insured which leads to numerous opportunities for fraud. A common ploy has been for the agent to give the finance company a wrong mailing address for the insured, particularly a post office box. Another common ploy is for an agent to use fictitious insured names.

Hazard associated with customer profile. Premium financing entails risk because it involves lending funds to individuals who otherwise cannot afford to pay their insurance premiums. Therefore, the regulator should review the financing company's lending guidelines and consistency in applying these standards.

Insolvency of the insurer. This situation occurs infrequently, since the financial condition of insurers is closely monitored to protect the public. Further, the premium finance company is protected by the various state guaranty funds to the extent that the

funds cover unearned premiums. The risk to the premium finance company is that in the event of insurer insolvency, the company will end up holding unsecured paper.

Safeguards for Minimizing Loan Losses

A premium finance company faces the potential for loan losses and should establish guidelines to guard against such risk. These guidelines should include standards for determining down payment amounts that adequately reflect the level of risk involved.

The service corporation's management should be able to demonstrate that the standards, at a minimum, take into account industry practices and "rules of thumb" regarding specific types of risk in this area. The following are examples of safeguards to be considered:

Cancellation risks. Typically, an insurer will cancel a policy on a pro rata basis, and some states require them to do so. If a policy can be canceled on a short-rate basis, the premium finance company should require a greater down payment. Similarly, if a third party, such as a lienholder on an automobile, is listed on the policy, additional notice must be given to the lienholder. In these cases, the lender should also require a greater down payment.

Auditable premium policies. On an auditable premium policy, the lender should generally require at least a 30% down payment; more if the case is deemed riskier. An auditable premium policy is one where the deposit premium is not the annual premium, rather it is determined by an audit of the actual results. This is the case with workers' compensation insurance. These policies are not collateralized, and the premium finance company should not finance such a policy unless it is collateralized with a payment guarantee bond.

Seasonal business policies. Financing policies on seasonal business generally involves insurance policies with shorter terms. The premium financier should develop a system to recognize that the equity reflects a shorter earning period.

Minimum earned premium policies. When a policy states that no matter when it is canceled, there is a minimum earned premium (stated as a dollar

amount or a percentage of the total premium), the minimum down payment should be the minimum premium plus an appropriate percentage of the total annual premium. This is often the case with workers' compensation, and excess and surplus lines.

Non-financeable policies. Policies that are essentially non-financeable should not be accepted as collateral by the lender. These include bonds, event policies (i.e., policies covering a fund-raising bazaar), policies underwritten by non-insurance companies, and life insurance policies (if a life insurance policy is canceled, no premium is returned). Horse mortality insurance is another non-financeable policy. The premium finance company should be named as loss payee in the first position. Otherwise, should the horse meet an early demise, there is no reason to pay the insurance, and the premium is fully earned.

To facilitate the regulator's review of the service corporation's guidelines, management should be able to provide supporting documentation that practices and policies are adequate for minimizing or containing exposure to loss.

INSURANCE PRODUCTS SOLD THROUGH SERVICE CORPORATIONS

In addition to understanding the aspects of various service corporation insurance activities, the regulator should be aware of certain types of insurance products typically sold through these entities. A thrift's service corporation that has a licensed agency may sell life, health and property insurance products to a variety of audiences, including the thrift and its employees, its customers, the general public and other business entities. [Note: The OTS generally prohibits the sale of private mortgage insurance and directors' and officers' liability insurance.]

The extent to which state-chartered thrifts may own insurance producing service corporations varies by state. Depending on the type of insurance products offered, the service corporation and its agents must have a valid life insurance agent's license or a property/casualty license. Service corporations often sell one or more of the insurance products discussed below.

Mortgage Life, Disability and Unemployment

These policies either make payments for a specified period of time or provide a lump-sum payment depending on the terms of the contract. Term life insurance, for example, is often used in conjunction with a home mortgage. Such a policy expires when a mortgage is paid off and offers protection to a surviving spouse or other dependent. On the other hand, disability insurance is designed to replace a portion of a worker's income when disabled by a covered cause. Similarly, unemployment insurance provides a portion of income, for a limited period of time, to a policyholder that subsequently becomes unemployed.

Credit Life on Consumer Loans

These policies pay off consumer loans if the borrower dies before repayment. They are usually offered on a group basis, as in the case of mortgage life, and in some states may be sold by licensed employees of service corporations even if no agency exists. The regulator should verify that management's internal controls serve to ensure compliance with state regulatory limitations and requirements. A federal thrift's service corporation may offer credit-related life insurance to borrowers and term life to non-borrowers in the absence of contrary state regulation. However, credit life requirements on loans from thrifts should not impair the borrower's freedom of choice as to providers.

Life Insurance for Savers

The following types of insurance are typically available for savings customers and may be sold in most states by licensed service corporations.

Term insurance. Term insurance is often referred to as pure life insurance. It is a basic type of insurance that offers temporary protection and no cash value or savings element. Policies are typically issued for periods of one, five or ten years, or until the insured reaches a certain age. Most term life insurance policies are renewable and convertible. Convertible policies can be exchanged for some form of cash value policy (i.e., whole or universal life insurance) without the insured having to show evidence of insurability.

Whole life insurance. As with term insurance, there are a number of forms of whole life insurance. Most types provide lifetime protection to age 100. If the insured is still living at that time, the policy “endows” with the guaranteed cash value equaling the face amount of the policy.

The primary attractions of whole life insurance are that the policy affords life-time protection and that it saves money, while term insurance does not. Whole life policies accumulate cash values. The policy can be surrendered for its cash value or the cash can be borrowed under the policy’s loan provisions. Generally, premiums for these policies are level throughout the life of the policy.

Universal life. This coverage has overshadowed the traditional whole life policy because the latter offers limited interest rates in its savings component. Universal life has a pure insurance component and a professionally managed investment component. This form of coverage is extremely flexible and complex, and demands a well-trained sales staff.

Variable life. This is similar to universal life, except that instead of requiring the cash value portion of the policy to be invested in a portfolio, it may be placed in the insured’s choice of stock, bond or money market funds. The policy allows for appreciation of the fund to be tax deferred and pays for part of the insurance with pre-tax dollars. Generally, a security broker’s license, as well as an insurance agent’s license must be obtained to sell variable life insurance policies.

Annuities. These contracts provide for periodic distributions to an annuitant for a specified period or for life. They may be funded with a single premium or with a series of payments. The accumulation of value may be tax deferred, but withdrawals against the tax deferred accumulated value are subject to taxation by the federal government. Also, early withdrawals are typically subject to a penalty. Annuities may be fixed or variable. In most states, an agent must have a security’s license to sell variable annuities.

All or part of an annuity may be based on common stock investments, or may be related to such indices as the cost of living index. There is great latitude between various annuities. For example, some income payments are fixed and guaranteed.

With other plans, income payments vary with the value of the investment on which they are based. Some plans allow for a combination of the two.

Deferred compensation programs. Profit sharing or stock bonus plans allow the employee to defer taking income in cash until a later time, presumably after retirement. Under these plans, the employee’s deferred income is not taxed. The deferred income will be taxed at disbursement, but if this is after retirement, taxation will usually be based on a lower income. Under “401(k)” plans, contributions can be withdrawn with no penalty in the event of financial hardship, or when the employee leaves the company. These withdrawals are subject to taxation. An individual retirement account (IRA), however, usually imposes a penalty for early withdrawal. An employee leaving a company sponsoring a plan may roll the money over into another approved 401(k) plan or into an IRA, or keep the money and have it subject to federal taxation.

Property-Casualty Insurance in General

Automobile and homeowners’ policies as well as other forms of property and casualty coverage are commonly sold through insurance agencies.

Life-Health Insurance in General

Various forms of life and health insurance (medical, hospitalization, physicians’ fees) may be sold through service corporation agencies. Health insurance can be grouped into the two broad categories of medical and disability insurance.

Insurance on the Institution and its Employees

An institution obtains a variety of insurance coverages on its employees and on itself. Such coverages include:

- General liability insurance for the thrift and its employees;
- Hazard insurance on owned property;
- Workers’ compensation insurance (if allowed by state law);
- Errors and omissions insurance;

- Directors' and officers' (D&O) liability insurance;
- Life, accident and health insurance for employees; and
- Various types of fidelity coverages.

Many states consider these to be examples of controlled business and, therefore, limit the amount of such business that a service corporation may write.

Title Insurance

This type of policy is designed to protect lenders or borrowers from defects in real estate titles that are undiscovered at the time the policy was issued. Mortgage lenders often require mortgagors to obtain title insurance to protect the mortgage. Many states, however, preclude lenders' involvement in selling these coverages.

In summary, the insurance products described above are only some of the insurance products available through service corporations. Numerous other products, some of which are very similar to the policies described above, include (some of these are trade names): mortgage life, credit life, disability and unemployment; accidental death and dismemberment; bonus or complementary accidental death; graded benefit life; automatic travel; and travel accident. Several of these products are linked to a client's estate planning and are designed to meet long and middle term needs.

Insurance products must comply with applicable state insurance department requirements. Products such as variable annuities and variable life insurance must also comply with any applicable securities laws and regulations.

OVERALL RISK ASSESSMENT

In determining the overall risk presented to the parent thrift by a service corporation, the basic aspects of insurance activities and management controls for containing risk, as discussed in this Section, should alert the regulator to potential unsafe and unsound practices to be evaluated during an examination. Given the great number of possible forms of organization and the manner in which service corporations may wish to provide cover-

ages and services, the discussion has necessarily focused on general activities (i.e., agency, brokerage, underwriting, premium financing) and various risks that can increase the parent thrift's potential exposure to loss.

While the procedures that follow relate primarily to the insurance function, the regulator should also address general business concerns and the areas of review detailed in Handbook Section 730. The extent to which individual procedures are performed will depend on a number of factors, including the specific type of insurance operations (i.e., agency, underwriting, reinsurance), the specific product(s) offered, size of business, date of last state regulatory review, and those factors described in the Overview Section, especially the materiality of the parent thrift's service corporation investment.

REFERENCES

United States Code (12 USC)

Home Owners' Loan Act

§ 1464(c) Loans and Investments

Federal Deposit Insurance Act

§ 1828(m) Activities of Thrifts and Subsidiaries

§ 1831(e) Activities of Savings Associations

Code of Federal Regulations (12 CFR)

FDIC Rules and Regulations

§ 303.13(d) Equity Investments

§ 303.13(f) Notice of Acquisition or Establishment of a Subsidiary or the Conduct of New Activities

Through a Subsidiary
§ 303.13(g) Notice by Federal Associations Conducting Grandfathered Activities

OTS Rules and Regulations*Subchapter A: Organization and Procedures*

- § 516 Application Processing Guidelines and Procedures
- § 516.3 Definitions (Expedited and Standard Treatment)

Subchapter C: Regulations of Federal Savings Associations

- § 545.74 Service Corporations
- § 545.74(c)(6) Permitted Activities (Other Services)
- § 545.81 Operating Subsidiaries
- § 545.126 Referral of Insurance Business

Subchapter D: Regulations Applicable to All Savings Associations

- § 556.4 Control Over Placing of Hazard Insurance
- § 556.16 Insurance Agencies-Usurpation of Corporate Opportunity
- § 563.35 Tie-in Prohibitions
- § 563.37 General; Operation of a Service Corporation, Liability of Savings Associations for Debt of Service Corporation
- § 563.37(b) Service Corporation Debt
- § 563.170 Examinations and Audits; Appraisals; Establishment and Maintenance of Records

Part 567

§ 567.1(h)

§ 567.1(i)

§ 567.1(aa)

§ 567.9(c)

§ 571.21

Capital

Eligible Savings Association (Definition)

Equity Investments (Definition)

Subsidiary (Definition)

Deductions from Capital (Investments in Nonincludable Subsidiaries)

Maintenance of Separate Corporate Identities

Office of Thrift Supervision Bulletin

TB 23-2

Interagency Statement on Retail Sales of Nondeposit Investment Products

Insurance Program

Examination Objectives

To determine the level of risk that the related organization's insurance activities present to the parent thrift and to recommend corrective actions as necessary.

Examination Procedures

Level I

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1. Perform the appropriate examination procedures in Handbook Section 730.

2. Review the previous report of examination and all insurance-related exceptions noted and determine if management has taken appropriate corrective action.

Level II

3. Review a copy of:
 - The most recent state insurance department examination report and any complaint, claims handling or market conduct reports;
 - The most recent public accounting report;
 - The most recent NASD or SEC examination report, if applicable;
 - All written agreements pertaining to the insurance operation;
 - The insurance license for each state in which the entity operates; and
 - Production and complaint reports from insurer(s) represented by the service corporation.

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| 4. | Determine the type(s) of insurance activities and structure (i.e., agency, underwriting, reinsurance, brokerage, finance company) and the products being sold, underwritten or serviced (i.e., auto, homeowners, credit life, accident, health). | |
| <hr/> | | |
| 5. | Determine the adequacy of management's internal controls for ensuring compliance with any written agreements and applicable state regulatory requirements or securities rules and regulations. | |
| <hr/> | | |
| 6. | If agreements with third parties exist, verify that: <ul style="list-style-type: none">• They were approved by the service corporation's board of directors;• The parent thrift is not a party to the agreement;• There are no provisions pertaining to the indemnification of a third party (unless prior OTS approval was obtained);• The agreement provides for the third party to assume liability for the actions of its employees; and• Fees (i.e., implementation or subscription fees) paid to a third party are made in accordance with the terms established in the agreement. | |
| <hr/> | | |
| 7. | Determine whether the safeguards set forth in TB 23-2 (i.e., disclosures, suitability standards, release of customer information, advertising, sales training), have been implemented for sales of variable annuities and insurance products that have investment features and occur on the thrift's premises or as a result of a customer referral. | |
| <hr/> | | |
| 8. | If insurance operations involve dual employees: <ul style="list-style-type: none">• Determine the adequacy of safeguards for avoiding customer confusion (i.e., sales are conducted in segregated areas, sales staff identify the company that | |

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they represent, compensation paid by the subsidiary or third party is separate from compensation paid by the thrift); and

- Determine if bonuses are offered as additional compensation/incentives, and review the qualifications for the bonus. [Note: Management must be able to demonstrate that bonuses are paid in accordance with state laws and regulations.]

Level III

9. When significant safety and soundness concerns are presented by agency or brokerage activities, the following procedures may be appropriate:
- a. Determine whether the service corporation carries adequate amounts of fidelity insurance and errors and omissions insurance.
 - b. Verify that internal audit procedures and controls have been established and are being followed.
 - c. Determine whether accounts receivable and accounts payable records are properly maintained.
 - d. Determine the average age of accounts receivable, and whether there are adequate reserves for uncollectables and charge offs. (Do reserves represent a significant proportion of total receivables?)
 - e. Determine whether premiums collected are sent to the insurer(s) regularly. (If not, indicate whether this is based on an agreement with the insurer(s).)
 - f. Review operating financial statements for the last three years to determine trends. (Is the agency posing a financial risk to the parent thrift?)
 - g. Review annual premium volume against business plan estimates. (The service corporation should generate sufficient annual premiums for the agency to remain viable as detailed in the business plan.)
 - h. Verify the financial soundness of insurer(s) represented by the service corporation through a review of Best's ratings and state insurance department reports. (Another source is the NAIC's IRIS Report, available by subscription.)

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- i. Determine whether management, on an ongoing basis, monitors:
 - significant changes in customer base from one year to another to determine whether changes meet overall marketing strategy, and if they are desirable;
 - product mix changes to determine whether they are in line with overall strategies; and
 - account mix to determine if any accounts comprise 5% or more of total revenue. (If so, concentrations may be high.)
- j. Review trust account balances to determine:
 - the account balances;
 - whether all monies owed to the insurer(s) and insureds are identified; and
 - adherence to procedures for deposit and payout.
- k. Review insurers' production reports against those of the agency and verify that they balance.
- l. Determine on what basis the agent(s) will be remunerated and whether the records indicate that this is being followed.
- m. Review the adequacy of internal controls in preventing agents from changing insurance applications to ensure approval by the insurer.

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10. Based on the materiality of supervisory concerns associated with underwriting, reinsurance, captives or risk retention, the following procedures may be appropriate:
- a. Review the insurer's annual statement, insurance expense exhibit and supporting documents to verify that the company is solvent under statutory accounting principles. (Also see Best's ratings or the NAIC's IRIS reports for evaluating the insurer's financial stability.)

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- b. Determine whether management routinely monitors changes in customer base and product mix, and takes action when required.
- c. Determine whether personnel with adequate expertise are being consulted when technical risks are being insured or reinsured.
- d. For reinsurance operations, determine whether internal policies provide that:
 - management reviews an insurance company's underwriting policies before accepting its business;
 - rates and contractual terms reflect the degree of risk being assumed; and
 - systems are capable of estimating when a large claim will be presented.
- e. Verify that adequate allowances are made for loss reserves.

-
11. When premium financing activities present material risk to the parent thrift, the following procedures may be appropriate:
- a. Determine whether internal systems and controls ensure that operations comply with state laws and regulations (i.e., limitations pertaining to interest (finance) charges, cancellation and late charges, number of days' notice to give on cancellation, language and format of notice, and contract language and format).
 - b. Review for specific risk to the finance company:
 - fraud by an agent through use of a wrong address or fictitious name for an insured; and
 - insurer insolvency.
 - c. Verify that management has established guidelines that serve to minimize risk associated with potential loan losses (i.e., require minimum down payments that reflect the level of risk involved). (Management should be able to demonstrate that these guidelines are consistent with industry norms or "rules of thumb" in this area.)

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- d. Determine whether internal policies prohibit the approval of non-financeable policies when the premium finance company is not listed as the first loss payee.

Examiner's Summary, Recommendations, and Comments

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Prepared By:

Reviewed By:

Docket #:

CHAPTER: Other Activities

SECTION: Related Organizations

Section 730

INTRODUCTION

The examination of related organizations is essential in evaluating the overall safety and soundness of a savings association. Related organizations can significantly affect the operations and overall financial condition of their parent thrift. The purpose of the examination is to determine the extent to which the related organization poses a risk to the parent thrift. In identifying areas of risk, the regulator must fully understand the relationship between the parent thrift and its related organizations. This relationship will vary depending on, among other considerations, the amount of the parent thrift's investment, the organization's activities, the extent to which business is conducted through multiple "lower tier" entities, and restrictions imposed by regulation.

This Section provides the regulator with an overview of the types of related organizations that thrifts may establish, applicable regulations and restrictions, and issues of safety and soundness that are particular to the examination of related organizations. A discussion of the general approach to conducting examinations of related organizations is provided in the latter part of this Section along with examination procedures.

For purposes of this Section, the term "related organizations" refers to subsidiaries of thrifts and includes service corporations (their lower tier subsidiaries and joint ventures or limited partnerships), operating subsidiaries, and finance subsidiaries. *A thrift "affiliate," as defined under 12 CFR § 563.41, is not included in this definition of a related organization.* For example, under § 563.41, a savings and loan holding company is an affiliate of its subsidiary thrift and its related organizations. Transactions between an association (or its subsidiaries) and an affiliate are governed by 12 CFR §§ 563.41 and 563.42. Also, refer to the Holding Companies Regulatory Handbook, Section 400, Transactions with Affiliates.

Unless stated otherwise, this Section specifically refers to a federal thrift's authority to establish subsidiaries and to conduct activities through these

entities. To determine whether similar authority exists for state-chartered associations, the state laws and regulations must be consulted. Generally, a state savings association's authority to invest in and conduct activities through related organizations may not, under 12 CFR § 303.13, exceed that specifically permissible for a federal thrift unless prior FDIC approval is obtained. (Only state thrifts in compliance with their fully phased-in capital requirement are eligible to apply to the FDIC for such approval.)

All insured thrifts are required to notify the OTS (§ 563.37) and the FDIC (§ 303.13) at least 30 days prior to establishing or acquiring a subsidiary or conducting a new activity in an existing subsidiary. Unless specific application requirements apply, the OTS will accept a notification in the format filed with the FDIC. The regulator should determine whether the subsidiary was established and is operating as proposed and that related activities are limited to those described in the notification as approved by OTS order.

TYPES OF RELATED ORGANIZATIONS

There are basically three types of related organizations: service corporations, operating subsidiaries and finance subsidiaries. Each type of related organization is subject to a specific regulation. Service corporations and their subsidiaries are subject to 12 CFR § 545.74, operating subsidiaries are subject to § 545.81, and finance subsidiaries are subject to § 545.82. The following discussion provides greater detail concerning the regulatory requirements and restrictions that pertain to each type of related organization.

Service Corporations

Service corporations and their subsidiaries provide federal thrifts with several benefits, including investment in activities that the parent thrift may otherwise be prohibited from engaging in directly. (For federally chartered thrifts, such activities currently include securities brokerage and real estate

development.) Additionally, thrifts might invest in a service corporation in order to: share ownership interest with other associations; pool resources for providing specialized and costly services; conduct business outside of the state in which its home office is located; offer employee compensation structures that are different from those offered by the parent thrift; or insulate itself from potential legal liability of financial losses arising from the activity.

Definitional Requirement

To satisfy the definition of a service corporation set forth in the Home Owners' Loan Act (HOLA) at 12 USC § 1464(5)(c)(4)(B), a corporation must be organized under the laws of the state in which the federal thrift's home office is located and its entire capital stock is only available for purchase by that state's savings associations and federal thrifts with home offices in the state.

Investment Limitations

In order to prevent concentration of assets and to minimize risk, the HOLA limits the amount that a federal thrift may invest in a service corporation. Section 545.74(d) provides that an association may invest up to 3% of its assets in a service corporation. Any investment in excess of 2% must primarily serve community, inner-city, or community development purposes (as defined by the regulation). Under certain circumstances, a federal thrift that meets its applicable capital requirement may, subject to restrictions, make additional conforming loans to its subsidiaries. Section 545.74(d)(2) should be consulted for details regarding the specific requirements for such additional lending to subsidiaries.

To determine the parent thrift's investment in service corporations, include equity plus all loans, guarantees, or take-out commitments of such loans, to service corporations. (Refer to Handbook Section 230, Equity Investments, for a worksheet detailing the calculation for investments in service corporations.) Investments in the service corporation's "lower tier" subsidiaries should also be included. These subsidiaries are generally subject to the same regulatory and statutory requirements imposed on service corporations.

Tiers of Service Corporations

The OTS differentiates among the various "tiers" of service corporations. First tier entities are subsidiaries owned by the parent thrift directly and lower tier entities are those in which a first tier entity, or its subsidiaries, has an investment. While the first tier service corporation must be incorporated where its parent thrift's home office is located, a lower tier, either a "subsidiary" or "joint venture," may be incorporated elsewhere.

To qualify as a *subsidiary* under § 545.74(a)(4), an entity must be wholly owned or a joint venture in which a service corporation, directly or indirectly, owns, controls or holds (with power to vote) more than 25% of the capital stock, is a general partner, or is a limited partner and contributed more than 25% of the limited partnership's capital.

A *joint venture*, as defined at § 545.74(a)(3), is any joint undertaking by a service corporation or its wholly owned subsidiary with one or more persons or legal entities. Joint ventures may take the legal form of a joint tenancy, tenancy in common, or partnership. (Refer to the Glossary in this Handbook for the definitions of these terms.) As defined here, a joint venture also includes an investment in a corporation other than a wholly owned subsidiary.

Permissible Activities

Once established, service corporations and their subsidiaries may engage directly, or indirectly, in activities that may otherwise be prohibited for thrifts. These activities must be "preapproved" by regulation, as detailed in § 545.74(c), or specifically authorized by the OTS or the FDIC. In determining whether a service corporation's activities are permitted, the regulator should review the charter of the parent thrift and the service corporation. As noted above, restrictions on activities may vary depending on whether the parent thrift has a state or federal charter.

Thrift management should be able to demonstrate that the service corporation's activities are permitted. Investments in a subsidiary that engages in impermissible activities or exceed regulatory limits must be promptly disposed of or brought into

compliance within 90 days as set forth at § 545.74(e), unless the FDIC has approved such practices. In addition, § 545.74(b) authorizes the OTS to limit or prohibit a service corporation's activities for supervisory reasons. When an examination reveals that an activity is not conducted in a prudent manner or that proposed activities would present substantial risk to the parent thrift, the regulator should require that corrective action be taken.

The following discusses in greater detail the regulatory requirements for investing in and conducting activities through service corporations, including preapproved activities, activities requiring prior OTS or FDIC notification or approval, and service corporation reporting requirements.

Preapproved Activities

A parent federal thrift eligible for expedited treatment under 12 CFR § 516.3 is not required to file an application with OTS in order for its service corporation to engage in the "preapproved" activities listed under § 545.74(c)(1) to 545.74(c)(7). The preapproved status of these activities does not relieve the parent thrift of the requirement to file 30-day notifications with the FDIC and OTS prior to commencing a new activity through an existing subsidiary.

Thrifts that are ineligible for expedited treatment under § 516.3 must, regardless of whether an activity is preapproved for federal thrifts, file a service corporation application in accordance with § 516.1, and obtain OTS approval to make any new investment in a service corporation that engages in an activity that a federal thrift is prohibited from engaging in directly.

The preapproved activities listed in § 545.74(c) are divided into six general areas and include:

Loans

Preapproved loan activities include originating, investing in, selling, purchasing (including purchasing participations in), servicing, or otherwise dealing in loans (including brokerage or warehousing):

- secured by real estate;
- for repairing, equipping, or improving real estate;
- for business purposes that are insured or guaranteed by an agency of the United States;
- for education;
- that are consumer loans, including inventory and floor planning; and
- for commercial purposes.

Note: The combined commercial loan activities of the parent thrift and its subsidiaries may not exceed 10% of the parent thrift's total assets. Where a corporation is owned by more than one thrift, each parent thrift must include a portion of the subsidiary's commercial loans based on its proportionate ownership of the service corporation.

Services Primarily for Financial Institutions

These preapproved activities include:

- credit analysis, appraising, construction loan inspection, and abstracting;
- developing personnel benefit programs;
- conducting research, studies and surveys;
- managing data storage facilities for duplicate records;
- conducting certain advertising involving brokerage and other services;
- serving as an escrow agent;
- providing liquidity management, investment, advisory, and consulting services;
- providing clerical, accounting, or internal auditing services;
- establishing, owning, leasing, operating, or maintaining remote service units; and
- purchasing office supplies, furniture and equipment.

Note: The foregoing are not preapproved for customers other than financial institutions.

Real Estate Services

Preapproved real estate services include:

- maintaining and managing real estate;
- managing a home owners association for rental projects;
- providing home ownership and financial counseling;
- providing relocation services;
- providing real estate brokerage for the parent thrift, service corporation, or a joint venture (but not for property owned by third parties);
- acquiring real estate for prompt development or subdivision, improvement, resale or leasing to others for improvement, or as manufactured home sites;
- acquiring improved real estate or manufactured homes to be held for rental or resale, remodeling, renovating, or demolishing and rebuilding for resale or rental; and
- acquiring, maintaining and managing real estate (improved or unimproved) to be used for offices and related facilities of a stockholder of the service corporation, or for offices and related facilities of the corporation. (To the extent that such activities are performed under a prudent program of property acquisition to meet the stockholder's present needs or reasonable future needs.)

Note: OTS approval of real estate activities is required if:

- the proposed activity would cause the outstanding aggregate book value of all investment real estate owned by a thrift and its service corporations to exceed its total capital (12 CFR § 567.5(c)); or
- the development, subdivision, and construction of improvements is not proposed to be completed within eleven years.

Securities Brokerage Services

Preapproved securities brokerage activities are subject to numerous requirements and restrictions set forth under § 545.74(c). The scope of these activities is limited to acting as executing agency, providing investment advice, and engaging in riskless principal transactions. A “riskless principal transaction” occurs where a dealer, after receiving an order for a security, purchases the security from another firm for its own account and concurrently sells that security to the customer.

Securities dealing, market making, underwriting, and investment banking; all of which entail purchasing and holding securities for the dealer's account, are not preapproved. As is the case for any activity that is not preapproved, an application may be filed with the OTS for consideration.

Note: A detailed discussion of the regulatory restrictions and requirements applicable to these services is provided in Handbook Section 710, Nondeposit Investment Sales, and Thrift Bulletin (TB) 23-2, Interagency Statement on Retail Sales of Nondeposit Investment Products.

Other Investments

Preapproved investments include:

- securities of corporations or partnerships authorized under Title IX of the Housing and Urban Development Act of 1968, 42 USC § 3931;
- a savings account of the parent thrift, provided that there is no special consideration given;
- certain investments in an interim federal thrift;
- certain tax-exempt bonds of state governments or political subdivisions thereof, and certain tax exempt obligations of public housing agencies;
- certain small business investment companies;
- interest-rate futures transactions subject to 12 CFR § 563.74;
- financial options trading subject to § 563.175; and

- other investments set forth under §§ 563.71 through .73 and § 545.76 and in 12 USC § 1464(c)(1)(C) through (F), (M) and (N).

Other Services

Preapproved activities referred to as “other services” include:

- preparing state and federal tax returns for individuals and nonprofit corporations;
- insurance brokerage or agency for liability, casualty, automobile, life, health, accident, or title insurance, but not private mortgage insurance;
- providing fiduciary services upon application to the OTS;
- issuing notes, bonds, debentures, or other obligations or securities;
- issuing and extending credit on credit cards and related operations;
- acquiring personal property for leasing;
- providing data processing services pursuant to 12 CFR § 545.138;
- issuing letters of credit; and
- purchase and sale of U.S. gold coins.

Activities “Reasonably Incident” to Preapproved List

Reasonably incident describes an activity that is necessary or convenient to the performance of a preapproved activity and is interpreted narrowly. An association must own a service corporation engaged in the underlying preapproved activity in order to invest in an activity that is reasonably incident. For example, a service corporation that is developing a housing subdivision might be preapproved to temporarily operate a water utility for homeowners until the project is completed. In determining whether activities are “reasonably incident” to preapproved activities, the regulator should consult with the OTS Chief Counsel’s Office.

Other Reasonably Related Activities

In order to invest in a service corporation that engages in an activity that is not preapproved, an association must file an application to obtain prior OTS approval. Additionally, each tier below the service corporation is limited to the same activities as the first tier unless specific approval is obtained for engaging in other business activities. Service corporations that are not wholly owned are similarly restricted by the regulation.

The OTS has approved applications to conduct the following types of reasonably related activities:

- underwriting mortgage life, mortgage disability, credit life, or credit disability insurance on borrowers or account holders of the parent thrift and its related organizations;
- reinsuring mortgage life, mortgage disability, credit life, or credit disability;
- acting as a collection agency for third parties;
- referring clients to mutual fund brokers;
- underwriting mutual funds;
- exchanging foreign currency;
- acting as a mutual fund administrator; and
- sponsoring, distributing and selling investment company shares.

Management must be able to demonstrate that it has obtained the necessary authority to engage in any activity that is not preapproved under § 545.74(c). The regulator should verify that the service corporation is conducting such activities in accordance with any approval conditions that may have been established in an effort to address potential legal and supervisory concerns.

Service Corporation Reporting Requirements

Reports filed with the OTS are a primary source of data for verifying whether the parent thrift and its service corporations comply with relevant activities restrictions and investment limitations. A parent thrift must maintain two sets of books for reporting its investment in service corporations and

their subsidiaries. One set is to be prepared in accordance with generally accepted accounting principles (GAAP), while the other must meet OTS reporting requirements set forth in the Thrift Financial Report (TFR) Instruction Manual.

GAAP Reporting Requirements

Generally, a thrift's investment in a related organization should follow GAAP. GAAP requires consolidated financial statements for multiple organizations. Under GAAP, investments in related organizations must be recorded under one of three accounting methods (i.e., consolidation, equity, or cost). The appropriate accounting method depends on the extent of ownership and the extent to which control can be demonstrated over the related organization.

A discussion of GAAP reporting methods is provided in Handbook Section 230, Equity Investments. Accounting guidance is also provided in Accounting Research Bulletin (ARB) No. 5, Accounting Principles Board Opinion (APBO) No. 18, and Statement of Financial Accounting Standards (SFAS) No. 94.

OTS Reporting Requirements

In reporting its investment in service corporations and their subsidiaries, the parent thrift must follow one of four OTS reporting methods described in the instructions to the TFR (i.e., line-for-line consolidation, combination of consolidated first tier entities, equity, or cost). These reporting methods are not necessarily consistent with GAAP accounting methods.

A significant exception to GAAP, under OTS reporting requirements, is that service corporations and their subsidiaries are not consolidated with the parent thrift in the Unconsolidated Schedules of the TFR. For purposes of the unconsolidated Statement of Condition (Schedule SC) and Statement of Operations (Schedule SO), the equity or cost method under GAAP accounting is used to report the results of an association's investment in service corporations and their subsidiaries.

For purposes of the consolidated schedules, data is reported in two columns. The first column includes

all first tier service corporations and joint ventures. The second column includes all of the parent thrift's related organizations including those reported in the first column and operating and finance subsidiaries which are consolidated with the parent thrift on a line-by-line basis on unconsolidated TFR schedules.

For reporting data in the first column, a parent thrift that consolidates a first tier service corporation for GAAP purposes must incorporate the lower tier entities into the financial results of the first tier entity. When a parent thrift accounts for its investment in a first tier subsidiary by a method other than consolidation, the first tier and lower tier subsidiaries are not consolidated, but are reported in Schedule CSS (Consolidated Subsidiary Listing).

The following schedules are reported on a consolidated basis:

- Consolidated Statement of Condition (Schedule CSC) reports assets liabilities and capital;
- Consolidated Statement of Operations (Schedule CSO) reports income and expense;
- Consolidated Supplemental Information (Schedule CSI) reports asset quality, loan servicing, commitments, contingent liabilities, hedging activity, mortgage loan activity, and housing related balances;
- Consolidated Subsidiary Listing (Schedule CSS) reports information on all subsidiaries; and
- Consolidated Capital Requirement (Schedule CCR) reports calculations of capital requirements.

(For detailed guidance on evaluating the accuracy of reports filed with the OTS, refer to the TFR Instruction Manual.)

Operating Subsidiaries

As of November 30, 1992, all federal thrifts are authorized to establish or acquire one or more operating subsidiaries pursuant to § 545.81. Operating subsidiaries are subject to examination

and supervision by the OTS to the same extent as the parent thrift. State law should be analyzed to determine whether a state savings association can invest in an operating subsidiary.

Definitional Requirement

Section 545.81 defines *operating subsidiaries* as corporations that meet all of the following requirements:

- engages only in activities that a federal thrift is permitted to engage in directly;
- the parent thrift owns directly, or indirectly, more than 50% of the subsidiary's voting stock; and
- no person or entity other than the parent thrift may exercise "effective operating control" over the subsidiary.

The regulation does not identify scenarios under which "effective operating control" may be exercised. Through the notice and application processes and examination procedures, the OTS must analyze, on a case-by-case basis, specific facts and circumstances to determine whether such control is present.

In accordance with § 545.81, the parent thrift and its operating subsidiaries must be consolidated in accordance with GAAP, on a line-by-line basis, and treated as a single unit for purposes of reporting to the OTS and for applying appropriate regulatory requirements and limitations, unless otherwise stated by a specific regulation or policy.

Although operating subsidiaries are treated as a department of the parent thrift, they must maintain a separate corporate identity in accordance with the provisions of §§ 571.21 and 563.37 (as discussed in this Section under "Examination of Related Organizations").

Purpose and Benefits

The rationale for authorizing federal thrifts to establish operating subsidiaries is to provide thrifts with flexibility in structuring their operations. Section 545.81 also enables federal thrifts to have parity with national banks, which have been au-

thorized to invest in operating subsidiaries for quite some time.

An association may choose to form an operating subsidiary for, among other purposes: enhancing the thrift's ability to structure its operations to maximize efficiency and cost savings; managing some of its activities as separate businesses (with, for example, different employee schemes); pooling resources and spreading the cost of high overhead among several thrifts for such capital intensive services as data processing and maintenance of business records; insulating potential liability that would result if the activity were conducted directly by a parent thrift; using its investment to acquire interests in ongoing concerns or to acquire specialized knowledge from nonthrift sources; and attracting outside capital.

The following discussion outlines regulatory requirements for establishing or acquiring operating subsidiaries, highlights related issues on ownership structure, and compares operating subsidiaries and service corporations.

Procedural Requirements for Investments in Operating Subsidiaries

An association that is eligible for expedited treatment, as defined in 12 CFR § 516.3, must provide written notification to the OTS (§ 545.81) at least 30 days prior to establishing or acquiring an operating subsidiary, or performing new activities in an existing subsidiary.

The notification, at a minimum, describes how an activity will be funded, states the amount and form of the investment and the thrift's percentage of ownership, and lists the other shareholders. For acquisitions of existing subsidiaries, the notification also states the terms and conditions of the acquisition, provides documentation that supports the purchase price, and includes operating statements for the previous three years.

Section 545.81 requires thrifts that are ineligible for expedited treatment to obtain OTS written approval prior to establishing or acquiring an operating subsidiary, or conducting new activities in an existing subsidiary. Through the application process, an association must affirmatively demon-

strate that the establishment of an operating subsidiary or any proposed new activities will improve the financial and managerial condition or safe and sound operation of the parent thrift.

A thrift must also obtain approval under 12 USC § 1467 (Regulation of Holding Companies) and 12 CFR § 574.6 to hold another thrift as an operating subsidiary. Under this structure, OTS assessment fees are based on the parent thrift's consolidated assets and CAMELS rating. The thrift operating subsidiary is not separately assessed.

The regulator should verify that the subsidiary complies with representations made to the OTS and the approval order. Specifically, the regulator should determine how the subsidiary's activities affect the operations of the parent thrift. Documentation that supports the OTS' approval may be useful and should be on file at the thrift.

A service corporation in existence as of November 30, 1992, may be deemed an operating subsidiary merely by maintaining certain internal records if the corporation meets the definition of an operating subsidiary; and the parent thrift is eligible for expedited treatment under 12 CFR § 516.3. A parent thrift that is ineligible for expedited treatment must obtain prior OTS approval to change the status of a service corporation that existed on November 30, 1992, to an operating subsidiary. During the examination, the regulator must review and ensure that adequate documentation exists, including a certification by the parent thrift's board of directors. The certification must provide a description of the activity, how the activity will be conducted, and a statement of the authority that the thrift is relying on for the conduct of such activity.

To alter a subsidiary's status from an operating subsidiary to a service corporation, or if the operating subsidiary fails to continue to qualify as an operating subsidiary, the parent thrift must notify the OTS and comply with regulatory requirements relating to service corporations.

Ownership Structure

The parent thrift must hold more than 50% of the subsidiary's voting stock to qualify as an operating subsidiary. In addition, no other entity may exercise "effective operating control" over the

company. When an operating subsidiary is owned by more than one thrift, only the majority parent may treat the entity as an operating subsidiary.

The regulation does not establish restrictions on the composition and identity of an operating subsidiary's minority shareholders. The minority shareholders are subject to initial review through the notice and application processes prior to the establishment or acquisition of an operating subsidiary, and remain subject to OTS review through examinations and off-site monitoring. The subsidiary's management should be able to demonstrate that minority shareholders do not exercise effective operating control over the entity.

An operating subsidiary's authority to issue preferred stock is not limited by regulation. However, if an event occurs that would enable the preferred shareholders to exercise voting rights and assume effective operating control, the entity would no longer qualify as an operating subsidiary. Perpetual preferred stock issued by an operating subsidiary to third parties that constitutes a minority interest is included in line item SC-799 of TFR Schedule SC (Statement of Condition). Redeemable preferred stock issued to third parties is reported on line item SC-760 of Schedule SC.

The examination procedures include a thorough review of the organizational structure and any changes in ownership that have occurred since the prior examination. Discussions with management will provide the regulator with additional information regarding issues of control.

Service Corporation Activities Compared With Operating Subsidiaries

The following distinctions between service corporations and operating subsidiaries should be noted:

Activities Restrictions

As discussed previously, the activities of *service corporations* may be somewhat broader than those permissible for thrifts as long as they are "reasonably related" to the activities of a federal thrift. *Operating subsidiaries* are limited to the activities that federal thrifts are specifically permitted to engage in directly.

Investment Limitations

A parent thrift's investment in its *service corporations* is generally limited to an amount that does not exceed 3% of the parent thrift's total assets. The federal regulations do not limit the amount that a parent thrift may invest in its *operating subsidiaries*. An investment limit for operating subsidiaries is unnecessary since no additional risk is presented by these subsidiaries because they may only engage in activities that are permissible for a federal thrift. The parent thrift's investment is reviewed during the examination. When a parent thrift's investment in its operating subsidiaries and related extensions of credit is determined to be excessive, the regulator should initiate measures to promptly address unsafe and unsound practices.

Calculation of Certain Regulatory Limits

Service corporations are generally not consolidated with the parent thrift for calculating regulatory restrictions. Exceptions include those limits that are based on total capital, total assets and loans to one borrower or otherwise required by OTS policy or regulation. The parent thrift and its *operating subsidiary*, however, will be consolidated, on a line-by-line basis, and treated as a unit of the thrift for reporting to the OTS and for applying appropriate regulatory requirements, unless otherwise stated by regulation or policy. In other words, the parent thrift must calculate regulatory limits to make loans and investments after consolidating its assets and capital, and reconciling intercompany transactions with those of the operating subsidiary with respect to: consumer loans; commercial loans; service corporation investments; personal property investments; education loans; community development investments; nonconforming loans; and unsecured construction loans.

Other areas affected by the requirement to consolidate include: loans to one borrower provisions, reporting requirements (i.e., liquidity and interest-rate risk), and the qualified thrift lender test (provided the parent selects to include the subsidiary's assets in meeting this test). With respect to the provisions of the Community Reinvestment Act (CRA), the effect of an operating subsidiary on the parent thrift's CRA evaluation will depend on

whether the operating subsidiary is engaged in activities that are relevant for CRA purposes.

Geographical Restrictions

Federal thrifts may only invest in *service corporations* chartered in the state where the parent thrift's home office is located. As a policy, however, the OTS differentiates among the various tiers of service corporations. First tier service corporations (directly owned by the parent thrift) must be chartered in the state where the parent thrift is headquartered while lower tier service corporations may be incorporated elsewhere.

In comparison, *operating subsidiaries* may be incorporated and operated in any geographical location where its parent may operate. An operating subsidiary that is a depository institution may accept deposits in any location, provided the subsidiary has federal deposit insurance.

OTS Reporting Requirements

OTS reporting requirements for operating subsidiaries are distinct from those for service corporations. *Service corporations* are not consolidated with the parent thrift for purposes of preparing the parent thrift's unconsolidated TFR (Schedules SC through MR). These subsidiaries are consolidated with the parent in Schedules CSC through CCR (consolidated schedules). OTS reporting requirements concerning the thrift's investment in service corporations and their lower tier subsidiaries differs from GAAP. (Information on OTS reporting requirements is set forth in the TFR Instruction Manual.)

As stated above, *operating subsidiaries* are treated as a department of the parent thrift. These subsidiaries are consolidated on a line-by-line basis, after elimination of intercompany items, with the parent thrift for preparing the parent's unconsolidated TFR. Thus, the separate entities are reported as if they are one unit and the parent thrift's compliance with statutory and regulatory requirements is determined on a consolidated basis.

When a parent thrift owns another depository institution as an operating subsidiary, the associations must file separate TFRs with the OTS. The parent

thrift should not consolidate its subsidiary institution on a line-by-line basis for reporting purposes. The OTS will, however, accept an annual audit on a consolidated basis and not, as a policy, require a separate audit for the thrift operating subsidiary. The parent thrift must, however, calculate regulatory requirements and restrictions based on a line-by-line consolidation with its subsidiary.

Finance Subsidiaries

In accordance with § 545.82, federal thrifts may establish one or more finance subsidiaries. The sole purpose of a finance subsidiary is to issue securities that a federal thrift may issue directly and remit the net proceeds of the issuance to the parent thrift. Finance subsidiaries are created through the transfer of assets or liabilities (collectively referred to as “transferred assets” for purposes of this Section) from the parent thrift to the subsidiary. Once established, the transferred assets are generally used as collateral for the subsidiary’s securities issuances.

The authority of state-chartered associations to establish a finance subsidiary is determined by state law. The regulator should review the laws of individual states in determining whether such authority exists. Section 563.132, however, defines a finance subsidiary to include a subsidiary of a state-chartered association that is in compliance with § 545.82. So, if a state-chartered thrift may establish a finance subsidiary, it is covered by the provisions of § 563.132. Therefore, the following discussion of federal regulatory requirements generally applies to state thrifts.

The creation of finance subsidiaries provides a means by which an association may reduce its interest-rate risk and control credit risk. Therefore, a review of the business plan and actual operations are important steps in determining whether the finance subsidiary is attaining its stated objectives.

Since the regulations governing a federal thrift’s authority to establish a finance subsidiary were first promulgated in 1985, subsequent statutory and regulatory provisions have eliminated some of the advantages for using finance subsidiaries. Most noteworthy is the effect of the OTS capital rule, implemented during December 1989, which eliminates the favorable capital treatment afforded to

these subsidiaries by requiring consolidation on a line-by-line basis with the parent thrift.

Finance subsidiaries continue to provide a means by which an association may build earnings, and obtain liquidity and capital, in accordance with a prudent plan for reducing interest-rate risk and credit risk. These goals can be achieved by the sale of an association’s assets through a separate subsidiary that is generally not subject to consolidation with its parent thrift if it becomes insolvent. This fact, combined with the high quality assets and minimal liabilities of such subsidiaries results in the subsidiary’s securities issuances generally being rated higher by national rating agencies than those of the parent thrift. This translates into reduced interest or dividend rates carried by the issuances, thereby providing a low cost source of cash flow for the thrift. Proceeds from the subsidiary’s securities issuances may be used by the parent thrift to make additional loans.

The higher ratings for the subsidiary’s securities can be attributed to the separate corporate structure of finance subsidiaries and the collateralization of most issuances providing greater protection to holders of the securities. Thus, the rating agencies focus on the assets collateralizing the securities rather than on the financial condition of the parent thrift. The regulator should review the ratings a security received when issued and note any changes that may have occurred since. A decline in ratings could indicate the marketplace’s awareness of problems. (For a discussion of rating definitions used by Moody’s and Standard & Poor’s refer to Handbook Section 540, Investment Securities.)

Another benefit provided through a finance subsidiary is that the parent thrift can remove “underwater assets” from its balance sheet by transferring the assets to its finance subsidiary. GAAP does not require thrifts to recognize losses upon a transfer of assets, yielding below market interest rates, to a wholly owned subsidiary. Assets transferred from the parent thrift may be used to collateralize the securities issuances of the subsidiary.

The restrictions imposed on asset transfers and other regulatory and procedural requirements associated with the formation, operation, ownership

structure, and transactions of finance subsidiaries are discussed below. The regulator should be able to assess the risk that a finance subsidiary affords the thrift by using the information presented in this Section.

Finance Subsidiary Ownership Structure

The common stock of a finance subsidiary must be 100% owned by the thrift capitalizing the subsidiary. The stock may not be transferred or assigned to any other person or entity without prior OTS approval. The regulations do not impose a similar restriction on the subsidiary's preferred stock that may be issued to persons and entities other than the thrift. Additionally, voting rights may be authorized for preferred shareholders, in certain circumstances for a limited period of time, as detailed under § 545.82(d).

Procedural Requirements for Establishing a Finance Subsidiary

Prior to establishing a finance subsidiary, the parent thrift must demonstrate, through a prudent business plan, that the subsidiary's operations will serve to reduce interest-rate risk and control credit risk. The thrift's board of directors must authorize, by resolution, the creation of the subsidiary and agree to make the subsidiary's books and records available to the OTS. In addition, the thrift must comply with the prior notification requirements of the OTS and the FDIC. Thrifts that are eligible for expedited treatment under § 516.3 must notify the OTS at least 30 days prior to establishing a new finance subsidiary, transferring additional assets to an existing subsidiary, or issuing additional securities through its subsidiary.

The regulator should compare the subsidiary's actual operations to those approved by the OTS. The notification must, at a minimum, include the amount of assets transferred and previous transfers from the parent thrift (including guarantees), and a calculation of the applicable asset-transfer limitation (amount representing 30% of the parent thrift's assets). The notification may also include a description of the securities to be issued, the estimated gross proceeds of the issuance, the current value of assets collateralizing the securities, or the anticipated interest or dividend rates and yields.

Thrifts ineligible for expedited treatment must, under § 545.82(f), obtain OTS approval prior to establishing a finance subsidiary, transferring additional assets to an existing subsidiary, or issuing additional securities through its subsidiary. The OTS approval takes the form of an order and may, for example, contain restrictions beyond those set forth in the regulations. Therefore, an assessment of whether the subsidiary complies with the approval order is an important aspect of the regulator's review.

Transactions Between the Parent Thrift and Finance Subsidiary

Asset and Liability Transfers Including Guarantees

Once proper notification or application has been made to the OTS, a federal thrift provides the capital to establish a finance subsidiary by transferring assets or liabilities to the subsidiary. The amount of assets transferred to the subsidiary are not subject to the loans-to-one-borrower limitations. The book value of transferred assets from the parent thrift to its subsidiary, however, may not, without prior OTS approval, exceed 30% of the thrift's total assets at the transfer date. Additionally, absent prior OTS approval, the market value of transferred assets may not exceed an amount necessary or customary for the securities to be issued, or 250% of the gross proceeds of the issuance, whichever is less.

In evaluating compliance with the asset transfer limitations, § 545.82(a) requires that the following be included to determine the aggregate amount of transferred assets:

- assets and liabilities used to capitalize the subsidiary, to collateralize a securities issuance, or to maintain collateral levels for a security issued by the subsidiary;
- guarantees issued by the parent thrift (with respect to securities issuances or any collateral for such guarantees);
- proceeds of a securities issuance that are held by the subsidiary for necessary expenses; and

- assets or liabilities received from the parent thrift in connection with the remittance of proceeds by the subsidiary.

The parent thrift's guarantees must state that the assets collateralizing the payment of the securities will be exhausted before recourse to the guarantor. Further, the thrift's guarantees may not exceed the sum of the unpaid principal balance plus accrued but unpaid interest, any redemption premium, and any post default interest on the securities. Also, for guarantees or transferred liabilities that are collateralized, the face amount (of the guarantee or liability) or the current book value of the collateral, whichever is greater, must be included in the amount of transferred assets.

The regulator should verify compliance with the transfer limitations and that the stated amount of transferred assets (book value) includes all assets actually transferred to the subsidiary. The transfer of an amount greater than 30% of assets would limit the parent thrift's ability to engage in other types of activities, particularly those for the provision of housing credit.

Remittance of Proceeds

The finance subsidiary is required to remit the proceeds of its issuance, net of reasonable costs, to the parent thrift. Reasonable costs include proceeds held in the subsidiary for collateral maintenance, fee payment, or any other necessary payments related to the issuance or collateralizing assets.

The regulator should verify that the remittance is occurring in a systematic manner and over a reasonable term. Proceeds can be remitted through:

- payment of dividends on common stock;
- redemption of common stock;
- repayment of any loan made as part of capitalization; or
- purchase of assets or liabilities issued by the parent thrift.

It is important to note that the remittance of proceeds does not reduce the amount of assets transferred to a finance subsidiary for purposes of the asset transfer limitation.

Issuance of Securities by Finance Subsidiaries

A finance subsidiary may issue, either directly or through a third party, any security that its parent thrift may issue directly. (A mutual thrift can establish a subsidiary to issue any securities that could be issued if the thrift were to convert to stock ownership.)

Section 545.82(f)(2) requires a parent thrift to notify the OTS within 10 days following the issuance of a security by its finance subsidiary. The notice should include a copy of a prospectus, offering circular, or other similar document. It is important to note that the subsidiary's securities may not be structured to accelerate payment, maturity, or redemption upon insolvency of the parent thrift or any receivership action taken by the FDIC.

Various types of financial instruments may be issued through finance subsidiaries, but a discussion of each type of security is beyond the scope of this Section. The specific advantages of issuing one type of security over another will vary depending on the objectives of both the thrift and the subsidiary. The regulator should review the thrift's business plan to determine whether the finance subsidiary is adequately meeting stated objectives. The most common forms of security issues through finance subsidiaries are preferred stock and collateralized mortgage obligations (CMOs).

CMOs

Through a CMO, the issuer transfers substantially all risks and benefits of ownership in the underlying mortgages to the investor. The actual risk assumed by the issuer depends on the frequency of principal and interest remittances to the investor, guarantees as to the maximum maturity of each class of securities, and any recourse obligations obtained by the thrift or subsidiary to absorb losses from the collateral on behalf of investors. (For a complete discussion of CMOs refer to Handbook Section 560, Deposits and Borrowed Funds, and Section 660, Derivative Instruments and Hedging.)

Preferred Stock

Under the OTS Capital Rule, a thrift may not include collateralized preferred stock as capital.

However, the issuance of collateralized preferred stock (frequently with variable market dividend rates) can still be attractive because of the tax advantage it provides to investors and the presence of a ready market for the issuances. Corporate investors can deduct a percentage of dividend income because, unlike debt, dividends are paid after taxes.

The regulator should review the subsidiary's reports pertaining to the terms of preferred stock issuances. This review is particularly important because mechanisms (unauthorized by the OTS) may exist whereby the shareholders can obtain voting rights. Through these unauthorized rights, an attempt may be made to replace the subsidiary's board of directors or sell subsidiary assets.

Oversight of Finance Subsidiary Activities

The thrift's board of directors must monitor the subsidiary's operations and performance on a regular basis. A finance subsidiary's activities must be solely limited to issuing securities that its parent thrift may issue directly. Any other activity could cause the entity to lose its status as a finance subsidiary and the benefits that accrue from its operation. Specifically, the subsidiary is prohibited from issuing or dealing in the deposits or savings accounts of its parent thrift, and may not state or imply that its securities are federally insured.

Representations Made to the OTS

Generally, the activities of a finance subsidiary are limited to the specific purposes for which it was created. The regulator should verify that the subsidiary has not incurred any other indebtedness, issued any other security, or used excessive levels (book value) of collateralization other than those essential to its limited function. Additionally, the board of directors should not authorize the subsidiary to issue securities that the thrift could more efficiently issue itself. The regulator can confirm that this has not occurred by verifying that a cost/benefit analysis was performed prior to the transfer of the assets to the subsidiary.

Objectionable Practices

While several legitimate benefits can accrue from the operation of a finance subsidiary, the regulator should be aware that these subsidiaries may be operated in a manner that is objectionable. For example:

The parent thrift capitalizes and lends funds to the subsidiary. The finance subsidiary locates an investment security to purchase with the intent of using the security to collateralize a CMO. Once the CMO is structured, the subsidiary consummates the transaction by simultaneously issuing the CMO and using the funds from the issuance to purchase the securities needed to collateralize the CMO. Additional collateral is provided by a loan to the subsidiary from the parent thrift.

In the example, the subsidiary is not purchasing the parent thrift's assets to collateralize the CMO offering, but is acquiring the assets from another entity. This transaction involves excessive leveraging of the parent thrift's assets. If the thrift includes the over-collateralization amount as the amount of assets transferred to the subsidiary and the subsidiary engages in a number of these issuances, the subsidiary could become larger than the parent thrift. This situation is considered an unsafe and unsound practice. The regulator can confirm that such practices are not occurring by verifying that the parent thrift has not exceeded the asset transfer limitation, as discussed above, without prior OTS approval.

Other potentially objectionable uses of a finance subsidiary include the: (1) transfer of marketable assets of a failing thrift into a finance subsidiary to collateralize the issuance of preferred stock or debt without OTS approval; (2) use of the finance subsidiary as a vehicle to provide tax losses for the thrift in order to generate a tax shelter for the holding company; (3) channeling or diverting of funds to other affiliates; and (4) use of the finance subsidiary as a device to permit otherwise prohibited transactions between a holding company, its subsidiary thrift, or other affiliates.

EXAMINATION OF RELATED ORGANIZATIONS

The ability to distinguish between the types of related organizations and their different operating and regulatory requirements is important in evaluating the relationship between a parent thrift and its subsidiaries. That relationship is reviewed through the examination of related organizations. Specifically, related organizations are reviewed by the OTS to determine the degree of risk that they pose to the parent thrift.

Regulators should review related organizations as part of the parent thrift's examination and in a manner that is consistent with the philosophical approach and examination procedures outlined in this Section. A review of this Section will provide an understanding of:

- The approach to examining related organizations. The approach is risk-focused, though it differs in important respects from thrift examinations.
- The methodology for defining the scope of an examination. The scope is initially determined through a pre-examination analysis and should be sufficient to provide a thorough understanding of the level of risk that the related organization presents to the parent thrift.
- The procedures performed during the examination. These are used to evaluate specific activities and practices of the subsidiary and their overall effect on the parent thrift. The level of procedures performed depends on the risk presented by the activities of the related organization.
- The primary areas of review in examining related organizations are management quality, asset quality, earnings and compliance. Examination procedures are used to evaluate these areas within the defined scope and, based on findings revealed, may lead to additional levels of review.
- The considerations for identifying and evaluating conflicts of interest. Related regulatory restrictions (i.e., usurpation of corporate opportunity, tie-in arrangements, loans to insiders)

are also discussed. A response to violations should be initiated to minimize the effect of improper practices on the parent thrift.

- The requirement of separate corporate identities for a parent thrift and its subsidiaries. While only a court of law may determine when a parent thrift may be liable for the debts of a subsidiary, there must be a review of potential or ongoing litigation to estimate the parent thrift's loss exposure attributable to the related organization's activities.
- The documentation process for examination findings. A single CAMELS composite rating is assigned to all related organizations based on the combined risk presented to the parent thrift.

Several sections of this Handbook are referred to or incorporated by reference. The guidance contained in these sections can be applied to the examination of both the parent thrift and its related organizations. Guidance pertaining to major activities (i.e., securities brokerage, real estate development, insurance) conducted through related organizations is provided in Handbook Sections 710, 720, and 740. Information on the review of mortgage banking operations is detailed in Handbook Chapter 570, Mortgage Banking.

Approach

A thrift's conduct of activities through a related organization can involve complex management issues, legal obligations to honor the organization's debts if separate corporate identities are not maintained, or a negative effect on the parent thrift's consolidated income stream. Conversely, related organizations may serve to isolate risky activities in a separate corporate entity, allow geographic expansion or joint investment opportunities with other thrifts, and provide increased consolidated earnings.

Examination Philosophy

The primary purpose of examining related organizations is to evaluate the level of risk that these entities pose to the parent thrift and thereby the insurance fund. The examination procedures at the end of this Section highlight the following four primary areas of review:

- management quality;
- asset quality;
- earnings analysis; and
- compliance.

In performing an examination, a risk-focused approach, similar to a “due diligence” approach should be employed. Due diligence is defined as the amount of activity ordinarily exercised and reasonably expected from a prudent and reasonable person. Due diligence is determined by the facts of each case and is not measured by an absolute standard. As applied to the examination of related organizations, due diligence suggests that the potential risk of loss to the parent thrift will determine the scope of the examination.

The foregoing examination philosophy does not mandate great detail, but serves to ensure that the scope of these examinations is both reasonable and prudent. Thus, the regulator should tailor the examination to the specific activities of the organization and identified areas that present material risk.

Levels of Procedures

Consistent with the risk-focused approach to reviewing related organizations, the examination procedures have been tiered into two levels. The level of procedures performed during an examination will depend on the types of activities conducted through subsidiaries and the materiality of the risk involved. Handbook Sections 710, 720, and 740 contain three tiers of examination procedures that may be used to evaluate activities commonly conducted through related organizations.

Level I procedures are usually performed at each examination and enable the regulator to obtain an overview of the organization’s condition and the parent thrift’s risk exposure. These procedures include a general analysis of management, financial statements, organizational structure, and compliance with regulatory requirements. Information revealed through a Level I examination may require further review and modifications to the examination scope to incorporate Level II procedures.

Level II procedures provide an in-depth analysis of a related organization. The procedures are only performed when an initial analysis reveals that the parent thrift may be exposed to substantial risk and should be tailored to address specific areas of concern. The appropriate level of review is initially determined through the examination scoping process. The level of review may be modified throughout the examination as additional information is evaluated and findings reveal the need for further analysis.

Examination Scope

Pre-Examination Analysis

The first step in establishing the examination scope is to conduct a pre-examination analysis to define the appropriate level of review. Information relevant to the analysis can be obtained from the following sources:

- Preceding examination reports and recent supervisory correspondence may highlight issues pertinent to the review.
- The Continuing Examination File (CEF) should contain copies of the charters, existing contracts and information on the related organizations’ relationships with the parent thrift and other entities.
- Recent Thrift Financial Reports (TFR) of the parent thrift include a list of the parent thrift’s subsidiaries and their activities, the amount of investment in subsidiaries and changes in that amount, and material variances or unusual conditions relevant to the organization’s operations.
- The Preliminary Examination Response Kit (PERK) should be reviewed to identify recent events that may affect the subsidiary’s operations. The entity’s audited financial statements should be provided with the PERK.
- The related organization’s business plan and pro forma statements set forth underlying assumptions to be considered, as well as operating strategies. A review of the parent thrift’s business plan may indicate the purpose

and objectives for investing in the related organization(s).

- Discussions with management of the related organization and parent thrift may disclose important plans or other information. Management is responsible for providing any additional information pertinent to the analysis.

The pre-examination analysis should lead to an initial examination scope that is broad enough for the regulator to obtain an accurate understanding of the parent thrift's organizational structure, related activities, and the materiality of the risk involved.

In performing an initial assessment of the potential risk that a related organization poses to its parent thrift, the following factors should be considered:

- the relative size (assets, capital, earnings, cash flow) of the parent thrift and subsidiary;
- the perceived risk of activities;
- the significance of debt and equity investments (Are they includable in regulatory capital?);
- the significance of contingent liabilities;
- the number of related organizations; and
- the cost of the examination in relation to the information to be gained.

Organizational Structure

Understanding the thrift's organizational structure is also a key element when defining the examination scope. Primary sources of information include the Consolidated Subsidiary Listing (CSS) of the TFR, the PERK, and discussions with management of the related organization and parent thrift.

An assessment of organizational structure will help to determine the effect of any changes on future operations or viability of the related organization, identify risks to the parent thrift, and assist in establishing the examination scope. For example, if substantive changes in organizational structure have not occurred since the previous examination, the review may be limited to an update of ownership interests. For an inactive organization, the examination can generally be limited to verifying

ownership interests and determining management's plans for selling or retaining the entity.

In the event that there have been changes in organizational structure or related activities since the prior examination, a re-evaluation of the related organization's operations and the effect on the parent thrift may be necessary. In evaluating the fit between structure and strategy, the regulator should:

- identify the organizational structure of the parent thrift and its related organizations;
- determine if the organizational structure is adequate for the pursuit of current activities;
- determine transactions and arrangements among entities within the organizational structure;
- determine the effect of changes on the related organization's operations; and
- identify deficiencies in organizational structure and alert management and the board to potential or existing problems in order to minimize the effect on the thrift.

A primary aspect in the foregoing analysis is how well the structure's organization compliments its activities. Factors that influence whether an organizational grouping is practical include the size, number, and location of organizations. The following characteristics, while not all inclusive, are indicative of an effectively organized group of related organizations: operating synergies exist; activities are easily monitored; and diversification is used to isolate risk.

This review of the coordination between the parent and its related organization is a key component in assessing the effectiveness of the organizational structure. The exposure to losses increases if the groups are not well organized, are too large or diverse, or are poorly controlled or monitored.

Evaluation of Primary Examination Areas

The pre-examination analysis and a review of the organizational structure provide the basis for determining the initial estimate of risk presented to

the parent thrift. This estimate determines the examination scope. Guidance pertaining to the pre-examination analysis and establishing an examination scope is provided in further detail under Section 060, Examination Strategy, Management, and Scoping.

The following primary areas of review are to be performed in accordance with the planned scope of the examination and the recommended level of procedures.

Management Quality

An understanding of executive management, including the board of directors, is essential to determine the effectiveness of the related organization's operations. Management's ability to implement goals, manage activities, and maintain an appropriate level of expertise will substantially affect the organization's success in meeting business plan projections and minimizing risk to the parent thrift. A review of the quality of management is necessary to:

- determine management's effect on the subsidiary's operations;
- gauge the resulting effect on the parent thrift; and
- detect ways in which the parent thrift affects the organization.

The quality of the related organization's management influences all phases of the subsidiary's operations and its ability to provide services. The related organization's financial soundness often depends heavily on management's capabilities and expertise. Additionally, management affects the entity's ability to implement corrective measures and respond to oversight recommendations by outside parties (i.e., the parent thrift, owners, independent auditors, regulators). A more detailed discussion on evaluating management is provided in Handbook Section 330, Management Assessment.

Asset Quality Analysis

Executive management is responsible for taking appropriate measures to minimize risk inherent in the related organization's asset portfolio. These

measures include ensuring that expertise is adequate relative to the organization's activities, implementing prudent policies and procedures, and adhering to internal asset review systems. Substantial risk exposure within the asset portfolio reflects poorly on management's ability to operate the subsidiary in a prudent manner.

There is a direct correlation between a related organization's effectiveness in acquiring and managing its assets and the thrift's long run return on investment in the entity. Therefore, reviewing the composition and soundness of the assets is necessary to analyze and assess risk to the parent thrift, as capital rules permit inclusion of related organizations' assets (or the thrift's investment in the organizations) in the determination of regulatory capital. Guidance on evaluating asset quality is provided in detail in Handbook Chapter 200, Asset Quality. The following discusses the purpose and aspects of reviewing a subsidiary's asset portfolio.

The primary objective in analyzing the related organization's asset quality is to determine and minimize loss exposure to the parent thrift. Additionally, the regulators should evaluate whether (1) the actual realizable value of an asset is fairly represented on a related organization's books; and (2) the protection against losses is commensurate with the degree of risk in an organization's portfolio. Specifically, the following should be considered:

Asset Underwriting

The regulator is concerned with whether management has sufficiently underwritten a particular activity or asset. The general characteristics of underwriting practices and standards are the same as those for the parent thrift, as discussed in Handbook Section 260, Classification of Assets. A key factor in the assessment of asset underwriting is an evaluation of the organization's policies and procedures.

Internal Asset Review and Classification Systems

These systems allow for early identification of existing and potential risks within the portfolio so that prompt measures may be implemented to minimize losses (see Handbook Section 260, Clas-

sification of Assets). The asset quality review generally involves sampling the organization's asset portfolio and estimating the risk of loss exposure as compared to management's estimates. (Refer to Handbook Section 209, Sampling.)

Methods of Determining Value

Assets must be accurately reported on the related organization's financial statements in accordance with GAAP. A sampling of asset values should assist in determining whether adjustments to asset values are correctly reported in the subsidiary's financial statements. Management should be notified of differences revealed in the review and provided with supporting documentation.

Valuation Allowances

The analysis of asset quality at the related organization level may be material to estimating loss and risk exposure to the parent thrift and potentially to the insurance fund. Related organizations should follow GAAP requirements for maintaining reasonable valuation allowances through periodic charges to income. The adequacy of valuation allowances should be evaluated in accordance with guidance set forth in Handbook Section 261, Adequacy of Valuation Allowances.

Review and classification of a thrift's investment in a subsidiary may be unnecessary when appropriate allowances have been recorded by the subsidiary and reflected on the thrift's books by reducing its equity investment.

Note: Subsidiary assets should be reviewed and may be adversely classified if consolidated by the thrift on a line-by-line basis (i.e., operating and finance subsidiaries). If the equity method of accounting is used to carry the thrift's investment in the related organization (i.e., service corporations, including their lower tier subsidiaries, and joint ventures or limited partnerships) as an asset, then the thrift's investment in the subsidiary should be reviewed and may be adversely classified. (See Handbook Section 260, Classification of Assets.)

If neither the thrift's investment in, nor the assets of, the related organization are includable in regulatory capital, then the effect of adverse

classification is immaterial to the regulatory effort. The findings revealed through the asset quality review may, however, have an effect on the organization's reported financial condition and operating results. These findings should be incorporated into the analysis of the subsidiary's financial condition to determine the effect on the thrift's financial reporting.

Earnings Analysis

This area of the examination involves analyzing the financial condition of related organizations. Earnings analysis is an integral part of the evaluation of a related organization and plays a critical role in identifying strengths, weaknesses, and areas of risk throughout the subsidiary. Earnings analysis is, therefore, a key element in assessing the subsidiary's effect on the parent thrift.

The regulator should refer to Handbook Chapter 400, Earnings, for guidance on analyzing operations. This guidance and relevant examination procedures enable the regulator to:

- establish the scope of the financial analysis aspect of the examination;
- identify practices that are potentially unsafe and unsound and formulate appropriate regulatory responses;
- assess the organization's operations and strategies;
- identify problem areas disclosed by the financial records; and
- obtain satisfactory explanations for all material variances of data from prior periods and budgeted amounts.

Accuracy of Reporting

Earnings analysis also involves assessing the accuracy and adequacy of the related organization's financial reports and records. Accurate reporting by the related organization is necessary to effectively monitor and evaluate the entity's operations, financial condition, and effect on the parent thrift. Guidance relevant to the review of financial statements and accuracy of reporting practices is

detailed in several Handbook sections (Section 410, Financial Records and Reports, Section 430, Operations Analysis). The OTS' reporting standards are detailed in the TFR Instruction Manual.

The discussion of the different types of related organizations addresses the regulatory and GAAP standards for reporting a thrift's investment in related organizations. Additionally, the regulator should verify that the thrift's investment in its subsidiaries is accurately reported in the calculation of OTS capital requirements. For purposes of the OTS Capital Rule (Part 567) and Schedule CCR (Consolidated Capital Requirement), a subsidiary is either "includable" or "nonincludable." The following is provided to highlight the distinctions between includable and nonincludable subsidiaries. For purposes of verifying the accuracy of Schedule CCR, the regulator should refer to Handbook Section 120, Capital Adequacy, the TFR Instruction Manual, and 12 CFR Part 567, the OTS Capital Rule.

- **Includable Subsidiaries**

Includable subsidiaries are those that are:

- engaged solely in activities permissible for a national bank;
- engaged in activities not permissible for a national bank, but solely as agent;
- engaged solely in mortgage banking activities;
- an insured depository institution or a holding company whose sole investment is an insured depository institution (acquired directly or indirectly by the thrift before May 1, 1989); or
- a subsidiary of a federal thrift existing as such on August 9, 1989, and was either previously chartered by a state savings bank prior to October 15, 1982, or acquired its principal assets from a state savings bank prior to this date.

Includable subsidiaries that are consolidated under GAAP are consolidated with the parent thrift for purposes of the capital standards. The subsidiary's assets are risk weighted in the same manner as the

parent thrift's assets. When a thrift has an ownership interest in an includable subsidiary that is not consolidated under GAAP, the consolidation is prorated for purposes of calculating tangible assets (defined under § 567.1), but not for regulatory capital.

- **Nonincludable Subsidiaries**

In general, these subsidiaries are engaged in activities that are impermissible for national banks. Section 567.9 (Capital Requirement) requires that a thrift's investments in (and loans to) nonincludable subsidiaries, made after April 12, 1989, be excluded from assets and capital, unless grandfathered.

Grandfathering provisions for subsidiaries engaging in impermissible activities, prior to April 12, 1989, are detailed in Part 567, OTS Capital Rule, and the TFR Instruction Manual. These provisions provide a transition period during which thrifts must exclude from assets and regulatory capital an increasing percentage of their investments in (and loans to) nonincludable subsidiaries. By July 1994, all investments in nonincludable subsidiaries must be excluded from assets and regulatory capital unless OTS prior approval is obtained to include the appropriate percentage of investment in certain real estate subsidiaries for a period after July 1994, but not to extend beyond June 1996. Thus, any investments in nonincludable real estate subsidiaries must be excluded from the thrift's assets and capital after July 1, 1996.

In addition to determining the overall financial condition of the related organization, the operations analysis can be an important source of information for the compliance review. The analysis should be particularly useful in determining whether the related organization's actual activities and operations are consistent with representations made to the OTS through the notification or application process, financial statements and other documents filed with the OTS.

Compliance With Regulatory Requirements

The purpose of the compliance review is to determine whether a related organization is in

compliance with relevant statutes, regulations and OTS agreements. Compliance encompasses the entire body of regulations with which related organizations must comply. Primarily, the regulator must determine whether the related organization:

- was established or acquired in accordance with applicable regulations and related policies;
- engages in only those activities or businesses that are authorized by law, regulation, or other authority (i.e., OTS or FDIC approval); and
- conducts activities or businesses in accordance with pertinent requirements as set forth in the regulations (including consumer regulations), policy statements, and OTS agreements.

The regulator should refer to the individual discussions on specific types of related organizations and their permissible activities. This will provide an understanding of the relevant regulatory requirements and additional issues to consider when conducting the compliance review.

Additional Regulatory Concerns

There are additional concerns that could be revealed in any one of the four areas of the related organization review. These include the existence of conflicts of interest and the failure to maintain separate corporate identities. These concerns are addressed in § 571.7 (Conflicts of Interest) and §§ 563.37 and 571.21 (Maintenance of Separate Corporate Identities). In addition, the OTS may address related supervisory concerns through its broader authority to prohibit unsafe and unsound practices.

Conflict of Interest Considerations

Conflicts of interest occur when the interests of an association clash with the personal interests of individuals or the business interests of entities associated with the thrift. Section 571.7 describes conflicts of interest as conflicts between the financial interests and soundness of thrifts and the personal financial interests of directors, officers, and other controlling persons, their families and their business interests.

Conflicts of interest frequently occur through related organizations for several reasons, including:

- related organizations typically receive less scrutiny from outside auditors and boards of directors than the parent thrift;
- recordkeeping can be incomplete and auditors and directors may hold related organizations to a lower recordkeeping standard (i.e., in terms of documentation, disclosure of transactions, board of directors minutes) than the parent thrift; and
- complex organizational relationships (i.e., multi-tier subsidiaries) between the thrift and its subsidiaries make transactions difficult to identify.

Conflict of Interest Policy

Although it is not a regulatory requirement, thrifts and their related organizations should develop a policy on conflicts of interest and a code of conduct for their officers and other employees. The existence of such a policy is particularly important if a strong potential for conflict exists (i.e., the thrift is owned or controlled by a real estate developer). Regulators can identify conflict of interest policies through written policies, board minutes, and interviews with management of the thrift or related organization. The mere existence of a conflict of interest policy does not, however, prevent conflicts of interest.

Indications of Abuse

Determining the existence of conflicts of interest is an important aspect of the related organization examination. Certain red flags that suggest potential conflicts of interest include: recordkeeping deficiencies; evidence of concealment of insiders' interests in certain transactions; frequent changes in auditors and legal counsel; frequent appearance of insiders' names on suspense item listings; and expense accounts with expenditures that do not correspond to services rendered.

Regulatory Prohibitions

In addition to identifying specific abuses, the regulator should be familiar with the following regulations:

- **Usurpation of Corporate Opportunity (§ 571.9):** One common and often subtle type of conflict of interest is usurpation of corporate opportunity. It is a breach of duty for an officer or director of a thrift to take advantage of a business opportunity for his or another person's personal benefit when the opportunity is within the corporate powers of the thrift or its subsidiary.

The opportunity must also be of present and practical benefit to the thrift. Examples of usurpation of corporate opportunity by directors and officers include: (1) purchasing real estate from a related organization at a below market price, or (2) engaging in business activities authorized for the parent thrift.

Additionally, § 571.9 stipulates that the thrift or its related organization is entitled to any benefit that arises from usurpation of corporate opportunity. The person or entity involved is also exposed to liability in this regard.

- **Tie-in Prohibition (§ 563.35(a)):** An association or its subsidiary may not grant loans on the prior condition that borrowers contract with any specific company for:
 - insurance services;
 - building materials or construction services;
 - legal services;
 - real estate agent or broker services; or
 - real estate property management services.

[Note: See 12 USC § 1464(5)(q), Tying Arrangements.]

- **Restrictions on Loan Procurement Fees, Kickbacks and Unearned Fees (§ 563.40):** Directors, officers, or controlling persons of the parent thrift, their immediate family members, and

their business interests, as defined in the regulation, are prohibited from receiving fees or other compensation in connection with the procurement of loans.

- **Loans by Thrifts to their Executive Officers, Directors and Principal Shareholders (§ 563.43):** The insiders of a thrift or its related organizations are subject to the restrictions contained in the Federal Reserve Board's Regulation O, 12 CFR § 215. This regulation governs extensions of credit by a thrift, or its subsidiary, to executive officers, directors, principal shareholders and their related interests.
- **Loans and other Transactions with Affiliates (§ 563.41 and § 563.42):** These regulations place quantitative and qualitative restrictions on loans or certain other transactions entered into by the thrift or its subsidiaries with non-subsidiary affiliates. (Refer to Section 400 of the Holding Companies Handbook for a detailed discussion on transactions with affiliates.)

OTS recognizes that it is impractical to identify every practice or condition that constitutes a conflict of interest. The absence of specific prohibition does not, however, imply tacit approval or permission of conflicts. (Refer to Handbook Sections 330, Management Assessment, and 360, Fraud/Insider Abuse, for additional information on conflict of interest considerations.)

Maintaining Separate Corporate Identities

In examining a related organization, the regulator must ensure that the parent thrift and its related organization maintain separate corporate identities. A separate corporate identity distinguishes the activities of the subsidiary from those of the parent thrift in a visible and obvious manner. Corporate separation protects the parent thrift from the debts and other liabilities of its related organizations. Based on this protection, litigation involving the subsidiary may not result in legal liability to the parent thrift. The parent thrift can lose this protection if a court of law finds that corporate separation has not been maintained.

At all times, a parent thrift should ensure that the separate corporate existence of its related organi-

zations is maintained. To facilitate the regulator's review of this area, a request should be made for a written representation (or legal opinion from the parent thrift) that it and the subsidiary conform to the OTS policy on maintenance of separate corporate identities in §§ 563.37 and 571.21.

Legal Status of Review

The regulator's review of corporate separability could be used as evidence in a court of law. Since the legal definition of separate corporate existence varies from state to state, the regulator should be aware of local precedent. Considerable legal expertise, familiarity with recent court cases, and knowledge of the state's law are required to reach a legal opinion on corporate separability. Therefore, the regulator should not reach a conclusion that the entities are not separate, but should focus on whether specific guidelines have been met and identify conditions that could give rise to a court finding that separate corporate identities are not maintained. If such an adverse finding is made, supervisory action should be taken to minimize or negate the effect on the parent thrift and the insurance fund.

Regulatory Standards

Section 571.21 contains five guidelines that provide a minimum standard for the maintenance of separate corporate identities including:

- The thrift and its related organizations should operate without intermingling their respective business transactions and keep separate accounts and records;

Note: Each related organization should maintain its own separate records that reflect only the transactions of that entity. Neither the subsidiary nor the parent thrift should have access to each other's files. For example, an insurance subsidiary should not have access to the appraisals in the loan files of the parent thrift.

Additionally, written management agreements between the subsidiary and the parent should specify the types of services that the parent is providing for its subsidiary and the specific costs of the services (such costs should be reasonable).

It is also noted that the bonding of an association and its wholly owned subsidiary in a single bond would not, in itself, compromise the separate corporate existences of the two entities. Further, related organizations may originate loans in the name of the parent provided the approval process is conducted by the parent thrift.

- The parent thrift and the subsidiary should observe separate corporate procedures;

Note: Each corporation should have a separate board of directors and should maintain separate minutes of board meetings that clearly identify and distinguish between the activities of each entity.

- Each related organization should be adequately capitalized with sufficient funds to operate as a viable business;
- Each subsidiary should be held out to the public as a separate corporation (mandatory under § 563.37); and

Note: For example, a subsidiary's office space should be clearly separate from that of its parent. All lease or rental contracts should reflect this separation. The name of the subsidiary should be sufficiently displayed on signs, doors, and letterheads to clearly identify the separate corporation. Advertising in mailings, newspapers, and other media should communicate that the related organization is providing the service and not the thrift. In-branch promotional materials should be displayed or distributed where the subsidiary's activities are conducted, and not where banking activities occur (i.e., teller windows, loan desks). There should not, for example, be any confusion as to whether the related organization's products and services are FDIC-insured. (Refer to TB 23-2 for a discussion of investment product sales activity conducted on the thrift's premises.)

- The parent thrift should not excessively dominate its subsidiary.

Assessing the Effect of Noncompliance

Considerations relating to the failure to maintain separate corporate identities include:

Piercing the Corporate Veil

Generally, a shareholder of a corporation is not liable for the debts of the corporation unless the shareholder guarantees an obligation of the corporation. A shareholder's liability is limited to the amount paid for the stock. In certain cases, however, a court may determine that a shareholder is liable for the debts of the corporation. This determination is due to "piercing the corporate veil," such that the shareholder and the corporation are recognized by a court as one entity.

Although courts do not normally determine that the corporate veil has been pierced where separate corporate entities exist, there have been rare instances of such rulings. Therefore, the related organization should be structured and operated so as to prevent creditors of an insolvent subsidiary from obtaining a court decision holding a parent thrift liable for the debts of the subsidiary. The corporate veil is most likely to be deemed pierced by a court when the parent thrift initially capitalizes a related organization in a grossly inadequate amount for the type of business to be conducted and the operations of a subsidiary are conducted as an operation of the parent thrift rather than as a separate and distinct entity.

Potential Litigation

Actual or pending litigation concerning corporate separation could have a significant effect on the financial position of the parent thrift. When corporate separation is not maintained, the parent thrift could become liable for damages awarded or alleged in litigation against the related organization. Where a court finds that the corporate veil has been pierced, damages that are beyond the related organization's and parent thrift's ability to pay may result in losses to the insurance fund.

The existence of past or pending litigation against the thrift concerning corporate separation should be determined by reviewing attorney letters, board minutes, and audit reports. Additional information on litigation should be obtained through a discussion with management. The actual and potential costs to the insured thrift should be identified using these primary sources: records of the parent thrift

and its subsidiary; appraisals; and attorney letters to regulators, the thrift, or the related organization.

The process by which the total potential costs are estimated should be carefully explained and documented. Any actual losses should be properly accounted for in the parent thrift's financial records. If the actual or potential losses are significant, consideration should be given to submitting an interim report in accordance with policies and procedures of the regional office.

Documenting Examination Findings

As detailed in this Section, the related organization's practices, activities, and financial condition, will generally determine the scope of review. An understanding of the distinctions between related organizations and the risk-focused review of these entities provide a framework for formulating conclusions regarding the degree of risk presented to the parent thrift.

The regulators' conclusions should be documented in the parent thrift's ROE along with supporting data. The ROE contains a supplemental page titled Related Organizations. Major issues identified during the organization's examination should be noted on the Examination Conclusion and Comments page of the parent thrift's ROE with a reference to specific comments and conclusions included in the supplementary page.

The risk-focused approach to documenting the related organization review differs from the comprehensive approach employed for thrift examinations (See Handbook Section 070, Overall Conclusions). The conclusions pertaining to the related organization's operations should primarily be limited to addressing the degree of risk presented to the parent thrift. The regulators' conclusions should be based on information set forth in self-contained work papers that clearly state the purpose of a particular area of review. (For guidance on completing work papers, see Handbook Section 011, Program Use.)

After the comments and report papers are prepared, related organizations are assigned a subfactor rating based on the combined risk that they pose to the parent thrift. The rating is based on the numerical scale of the CAMELS system (re-

fer to Handbook Section 071, CAMELS Ratings) and is included under the earnings section of the ROE. The subfactor rating should reflect the conclusions drawn by the regulators with regard to the risks posed by the related organizations' operations. (For a detailed discussion of the thrift examination process, see the Handbook Chapter on Administration. This chapter addresses the use of this Handbook, discussions with management, conduct of Agency personnel and so forth.)

REFERENCES

United States Code

Home Owners' Loan Act (12 USC)

§ 1464(c)	Loans and Investments
§ 1464(q)	Tying Arrangements
§ 1464(u)	Limits on Loans to One Borrower
§ 1468(a)	Affiliate Transactions
§ 1468(b)	Extensions of Credit to Executive Officers, Directors, and Principal Shareholders
§ 1468b	Powers of Examiners

Federal Deposit Insurance Act (12 USC)

§ 1828(m)	Activities of Thrifts and Subsidiaries
§ 1831e	Activities of Savings Associations

Housing and Urban Development Act of 1968 (42 USC)

§ 3931 et al.	National Housing Partnerships
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Code of Federal Regulations (12 CFR)

FDIC Rules and Regulations

§ 303.13(d)	Equity Investments
§ 303.13(e)	Corporate Debt Securities not of Investment Grade
§ 303.13(f)	Notice of Acquisition or Establishment of a Subsidiary or the Conduct of New Activities Through a Subsidiary

§ 303.13(g)	Notice by Federal Associations Conducting Grandfathered Activities
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OTS Rules and Regulations

Subchapter A: Organization and Procedures

§ 516	Application Processing Guidelines and Procedures
§ 516.3	Definitions (Expedited and Standard Treatment)

Subchapter C: Regulations for Federal Savings Associations

§ 545.46	Commercial Loans
§ 545.74	Service Corporations
§ 545.77	Real Estate for Offices and Related Facilities
§ 545.81	Operating Subsidiaries
§ 545.82	Finance Subsidiaries
§ 545.126	Referral of Insurance Business

Subchapter D: Regulations Applicable to All Savings Associations

§ 561.4	Affiliate
§ 561.45	Definition of Service Corporation
§ 561.46	Definition of Service Corporation Affiliate
§ 563.35(a)	Tie-in Prohibitions
§ 563.37	General; Operation of Service Corporation, Liability of Savings Associations for Debt of Service Corporation
§ 563.37(b)	Service Corporation Debt
§ 563.37(c)	Notice of New Activity
§ 563.38	Salvage Power of Savings Association to Assist Service Corporation
§ 563.40	Restrictions on Loan Procurement Fees, Kickbacks and Unearned Fees
§ 563.41	Loans and Other Transactions with Affiliates and Subsidiaries

§ 563.42	Additional Standards Applicable to Transactions with Affiliates (Section 23B)
§ 563.43	Loans by Savings Associations to their Executive Officers, Directors and Principal Shareholders
§ 563.44	Loans Involving Mortgage Insurance
§ 563.76	Offers and Sales of Securities at an Office of a Savings Association
§ 563.93	Lending Limitations
§ 563.100	Real Estate Lending Standards (Includable Subsidiaries)
§ 563.101	Real Estate Lending Standards
§ 563.132	Securities Issued Through Subsidiaries
§ 563.160	Classification of Certain Assets
§ 563.161	Management and Financial Policies
§ 563.170	Examination and Audits; Appraisals; Establishment and Maintenance of Records
§ 563.171	Compensation
Part 567	Capital
§ 571.7	Conflicts of Interest
§ 571.9	Usurpation of Corporate Opportunity
§ 571.21	Separate Corporate Existence of a Service Corporation
§ 574.6	Acquisition of Control of Insured Associations (Procedural Requirement)

Subchapter F: Regulations for Savings and Loan Holding Companies

§ 584.2-1(d)	Service Corporation Subsidiaries
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Office of Thrift Supervision Bulletins

RB 18	Issuance of Enforcement Policies
RB 30	Guidance on the Use of Salvage Powers to Exceed Loans to One Borrower Limitations
TB 23a	Sales of Securities

TB 23-2	Interagency Statement on Retail Sales of Nondeposit Investment Products
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Federal Home Loan Bank Board T Memoranda Series

T 79a	Indirect Investments in Permissible Investments Through Limited Partnerships
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Accounting Practices

Financial Accounting Standards Board, Statement of Financial Accounting Standards (SFAS)

No. 05	Accounting for Contingencies
No. 11	Accounting for Contingencies - Transition Method
No. 34	Capitalization of Interest Cost
No. 58	Capitalization of Interest Cost in Financial Statements that Include Investments Accounted for by the Equity Method
No. 66	Accounting for Sales of Real Estate
No. 94	Consolidation of all Majority Owned Subsidiaries

Accounting Principles Board, Opinions (APBO)

No. 18	The Equity Method of Accounting
No. 23	Accounting for Income Taxes - Special Areas (Undistributed Earnings of Subsidiaries and Investments in Corporate Joint Ventures)

Committee on Accounting Procedure, Accounting Research Bulletins (ARB)

No. 51	Consolidated Financial Statements
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Related Organizations Program

Examination Objectives

The overall objective of the related organization review is to determine the degree of risk that the related organization(s) presents to the parent thrift and to implement corrective actions as necessary.

Administration

To establish a risk-focused examination scope based on an understanding of the related organization and its effect on the parent thrift.

Management Quality

To assess the related organization's management expertise and performance through an evaluation of management policies, procedures and strategic planning.

Asset Quality

To ascertain the extent to which the related organization's practices serve to recognize and control risk inherent in the asset portfolio and properly value the parent thrift's investment.

Earnings

To identify factors relevant to the related organization's financial condition that may materially affect the parent thrift's operating results and financial condition.

Compliance

To determine whether the related organization is operated in accordance with laws, regulations, and policy directives.

Examination Procedures

Administration

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1. Perform a pre-examination analysis:
 - Gather and review the PERK and other background information (i.e., audit reports, correspondence with regulators, OTS approval orders, Continuing Examination File [CEF]).

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- Obtain an understanding of the related organization, its relationship with the parent thrift and issues pertinent to the review (i.e., review organizational charts and the effect of recent changes in the structure on the organization, assess the significance of the subsidiary's operations by comparing its activity levels and size to those of the parent thrift, determine the extent to which the parent thrift depends on the related organization's income).
 - Determine if the related organization is included in the parent thrift's regulatory capital.
 - Identify the ownership and controlling interests of the related organization and any lower tier subsidiaries.
-
2. Review the previous report of examination and all related organization exceptions noted and determine if management has taken appropriate corrective action.
-
3. Establish an initial examination scope.
-
4. Perform examination procedures relating to management quality, asset quality, earnings and compliance. (Generally, all relevant Level I procedures should be performed.)
-
5. Modify the examination scope, as necessary, and perform any additional procedures under Level II or other applicable Handbook sections (i.e., Handbook Section 710, Securities Brokerage, Section 720, Insurance, and Section 740, Real Estate Development).
-
6. Conduct meetings with management to review examination findings.
-

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7. Formulate a response to unsafe and unsound practices (refer to Handbook Section 370, Enforcement Actions, and Regulatory Bulletin 18) and make criminal referrals, if appropriate (see Handbook Section 360, Fraud/Insider Abuse).

-
8. Prepare report comments and assign a subfactor rating based on the combined risk that the related organization(s) poses to the parent association.

-
9. Recommend the timing and scope of the next examination and update the CEF, if applicable.
-

Management Quality

Level I

10. Identify key decision-making personnel and obtain an understanding of their responsibilities.

-
11. Verify that executive compensation arrangements have been approved by the organization's board of directors and do not present significant concerns that could lead to material financial loss to the parent thrift.

-
12. Confirm that policies (i.e., conflicts of interest), and procedures (i.e., internal controls detailed in Handbook Section 340) have been approved by the organization's board of directors and established for major areas of the entity's operations.
-

13. Obtain and analyze periodic reports submitted to executive management of the organization and parent thrift to determine their usefulness in monitoring the operations

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and condition of the related organization.

-
14. Verify that the related organization's board of directors has access to information necessary to make informed decisions.
-

Level II

15. Assess the expertise and performance of the related organization's directors. (Does the directorate operate independently of management and the parent thrift? Does the directorate provide adequate oversight? Do third parties report directly to the board of directors?)
-

16. Evaluate management's expertise (i.e., technical proficiency, knowledge of the legal and regulatory environment, leadership and administrative abilities) and performance in relation to internal goals and the parent thrift's objectives.
-

17. Assess management's practices (i.e., communication, adherence to plans and policies, internal controls, periodic review of policies, ongoing supervision, and monitoring of operations).
-

18. Determine the overall effectiveness of management as evidenced by the related organization's performance (i.e., determine if strategic planning is adequate, evaluate the feasibility of long range plans, and assess management's planning for staffing needs).
-

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Asset Quality

Level I

19. Determine whether asset quality can have a material effect on the parent thrift's regulatory capital.

20. When material, identify risks relative to asset types. (Is the subsidiary engaging in new activities? Does the portfolio consist primarily of one type of asset? Is management expertise adequate to manage the portfolio?)

21. When material, evaluate the adequacy of the organization's asset underwriting policies and procedures.

22. When material, determine the adequacy of the organization's internal asset review, classification, and valuation systems.

Level II

23. Assess the risk exposure of the organization's asset portfolio. (See Handbook Chapter 200, Asset Quality.)

24. Ascertain compliance with the related organization's underwriting policies and procedures.

25. Determine the effectiveness of internal asset review and classification systems.

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26. Determine whether asset valuations should be adjusted. (Was the correct valuation method used? Is the valuation allowance adequate?)

-
27. Perform the following for finance subsidiaries:

- Determine whether the security has been unnecessarily over- or under-collateralized.
 - Determine whether the amount of default and interest-rate risks of the new investments of the parent are greater than the same risks for the assets collateralizing the securities.
 - Determine whether the prepayment assumptions on underlying collateral are realistic.
-

Earnings Analysis

Level I

28. Review prior examination reports (and work papers), audit reports, additional regional office monitoring reports, and any analysis performed by regulators to ascertain strengths and weaknesses in the related organization's operations.

-
29. Evaluate procedures for completing and submitting timely reports to regulatory authorities.

-
30. Determine whether material changes in accounting methods have been implemented since the most recent external and/or internal audit.

-
31. Review debt agreements entered into since the prior examination for unusual requirements, covenants and parent association guarantees. (The agreement should state

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that the parent thrift is not liable for the debt, unless the parent has guaranteed the debt.)

-
32. Analyze the stability of operating results and explain trends, and material variances (from prior results or business plan projections) that materially effect the related organization's financial position (i.e., adequacy of capital, liquidity needs).
-

33. Determine the effect on regulatory capital due to asset valuation or other accounting adjustments.
-

Level II

34. Verify the accuracy of reports submitted to regulatory authorities. (If necessary, reconcile and determine the materiality of intercompany accounts.)
-

35. Evaluate deviations from acceptable accounting standards as identified in the external and/or internal audit reports.
-

36. Analyze the organization's ability to service and manage its debt and the risk related to debt guarantees made by the parent thrift.
-

37. Assess the effect of contingencies and commitments on the subsidiary and parent association. (Consider the subsidiary's asset size, liquidity position and capital level. Do policies and procedures exist for identifying and evaluating contingent liabilities? Are contingencies reported in accordance with FASB Statement No. 5?)
-

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38. Compare business strategies, marketing plans, and budgets to operating practices and results to assess the adequacy of long-range plans and the effect on the parent thrift.
-

39. Review a finance subsidiary's operations to:

- Compare the actual results of the financing structure with the business plan and the cost/benefit analysis to determine whether the parent association's goals have been achieved.
 - Determine whether the cost of each issue increases the effective interest rate of the security above limits in the business plan.
 - Determine whether the parent association has considered what effect unforeseen increases in payoffs would have on the effective interest rate of the securities issues.
-

Compliance

Level I

40. Determine whether the related organization was established in accordance with applicable regulations and policies. (Has the subsidiary complied with OTS notification or application procedures?)
-

41. Verify that the related organization engages in activities that are authorized by law, regulation, or other authority (i.e., OTS or FDIC approval).
-

42. Confirm that the related organization(s) is properly included or excluded from the parent thrift's regulatory capital.
-

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43. Verify that transactions with affiliates are in compliance with § 563.41 and 563.42.

44. Verify that extensions of credit to insiders are in compliance with § 563.43.

45. Confirm that potential conflicts of interest have been accurately represented to the related organization's board of directors.

46. Determine whether corporate separation has been maintained:

- Determine whether the related organization and parent association share common officers and directors.
- Determine whether transactions, accounts, records, and board minutes of the parent thrift and the related organization are kept separate.
- Verify that each entity is held out to the public as a separate corporation and has separate offices, signs, and letterheads.
- Determine whether services (and related compensation) between the parent association and subsidiary are detailed in a written agreement, and that borrowings from the parent thrift are covered by written loan agreements.
- Ascertain whether there is any actual or potential litigation involving corporate separation and assess the effect on the parent thrift.

Level II

47. Verify that reported activities are consistent with actual activities.

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48. Verify compliance with OTS approval orders, applicable regulatory requirements (i.e., consumer regulations, investment limitations, ownership requirements), policies and OTS agreements. (Regulatory requirements vary based on the type of subsidiary, its activities and whether the parent thrift is eligible for expedited treatment under § 516.1.)

49. Perform the following additional review for finance subsidiaries to:

- Determine whether assets are being purchased from entities other than the parent association.
- Determine whether the subsidiary is engaging in unauthorized arbitrage transactions.
- Determine whether any unauthorized action has occurred that could cause holders of preferred stock to exercise voting rights.

50. Confirm compliance with regulations pertaining to usurpation of corporate opportunity (§ 571.9) and restrictions on loan services (§ 563.35).

51. Determine whether financial losses have been incurred as a result of conflicts of interest.

52. Identify pending activities that could affect corporate separation.

Examiner's Summary, Recommendations, and Comments

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CHAPTER: Other Activities

SECTION: Real Estate Development

Section 740

INTRODUCTION

This Section supplements Handbook Section 730, Related Organizations, to provide greater detail when evaluating the effect of a service corporation's real estate development activities on the parent thrift. For purposes of this Section, the term "real estate development" refers to the development of land or other real estate for sale or lease in which the related organization has an ownership (equity) interest or actively manages the property. [Note: Real estate owned (REO), repossessed assets, and real estate held for use by a thrift or its subsidiary are not included in the definition of real estate development.]

Real estate development is an impermissible activity for national banks. As discussed in Handbook Section 730, subsidiaries engaged in activities not permissible for national banks are nonincludable for purposes of calculating OTS capital standards. Section 1464(t)(5) of the Home Owners' Loan Act (HOLA) requires that a thrift's investment in (and loans to) nonincludable subsidiaries made after April 12, 1989, be excluded from total assets and regulatory capital, unless grandfathered or authorized by the OTS under the transition rule. In accordance with HOLA, all such investments must be excluded from capital after June 30, 1996.

As discussed in the Related Organizations Section, the purpose of the related organization examination is to determine the extent to which the entity poses a risk to the parent thrift. Real estate development activity is inherently risky given the level of complexity often associated with the development process, reliance on estimated development costs and future cash flows, financing arrangements, and the potential effect of unforeseen events on project feasibility.

Federal associations and their operating subsidiaries are not permitted to directly invest in real estate, but may establish a service corporation for this purpose (including their lower tier subsidiaries, and joint ventures or limited partnerships) in accordance with § 545.74. (Refer to Handbook Section 730 for a summary of preapproved service

corporation activities and related OTS notification and application requirements.)

There are several methods that a service corporation can use to participate in real estate development. The service corporation can, through use of its own funds or borrowed funds (received from its parent thrift or other source):

- assume the role of development lender;
- provide an equity contribution as a passive investor; or
- act as an "active" investor/participant on an individual, partnership or joint venture basis.

The discussion that follows focuses on the service corporation developer that acts as an "active" investor or participant in real estate development activities. A primary distinction between passive and active real estate investors is that the passive investor's exposure to loss is generally limited to the amount of its initial investment while the active investor's financial liability can ultimately exceed its initial investment. In addition, unlike the active form of ownership, the passive investor must depend on the ability and performance of a party (i.e., general partner, developer) over whom it can exert little if any control. While the active and passive forms of ownership are substantially different, the risk assessment issues discussed below generally apply to both types of investments.

Although § 1464(5)(c)(4)(B) of the HOLA restricts the amount that a federal association may invest in a service corporation, a substantial level of risk can nevertheless exist within this limitation. The risk to the parent thrift increases when the service corporation's analysis of a real estate investment is flawed or the service corporation, as an active project participant, fails to implement prudent internal controls and policies during project development.

As discussed in the Overview Section, the purpose of the preexamination analysis is to establish an

examination scope that enables the regulator to obtain an adequate understanding of the related organization's activities and the materiality of the risk involved. In determining an appropriate scope of review, this Section provides the regulator with an overview of real estate development and practices that can serve to minimize the parent thrift's exposure to loss. Specifically, this Section discusses:

The Real Estate Development Process. There are four primary stages of real estate development: predevelopment, planning and design, construction, and marketing. The service corporation, as developer, serves as the focal point for all activity and will generally form a project development team that might include construction engineers, architects, or a general contractor.

Preacquisition Activity. The initial scope of the regulator's review should include an assessment of whether the service corporation has adequately evaluated the development project. There are fundamental aspects of evaluating a potential real estate investment that management and directors of the service corporation and parent thrift should consider prior to acquiring a property or commencing actual development or construction activity. Preacquisition activities should include an analysis of investment vehicles or forms of ownership to be used, project feasibility, appraisal information, and compliance with local, state and federal regulatory requirements. Even though a real estate project may be in the advanced phases of development during a scheduled examination, a review of preacquisition analyses will permit an initial assessment of the level of risk assumed by the service corporation. In addition, pro forma statements, plans and designs, and cost estimates can be compared to actual activity to identify existing or potential problems.

Postacquisition Oversight and Control. Once the property has been acquired, development begins. Construction contracts and financing arrangements are finalized to establish the obligations and responsibilities of project participants (i.e., developer, contractors, co-venturers, lenders), including insurance and bonding requirements during the construction phase. An adequate system for disbursing construction funds and monitoring stages of completion can provide for prompt identi-

fication of existing and potential risk factors (i.e., misuse of funds, cost overruns, breach of contract).

Postdevelopment Activity. The service corporation's role can include providing property management or leasing activities for completed projects. Several factors can affect the level of risk and profitability associated with such undertakings. A competent marketing or management team should be in place prior to completing construction.

In determining the risk presented to a parent thrift by a related organization's involvement in real estate development, the regulator needs to carefully review the entity's activities and operations as detailed in Handbook Section 730. The specific guidance and examination procedures that follow should be incorporated in the regulator's overall review in a manner consistent with the approach outlined in the Related Organizations Section. In addition, while a service corporation's preapproved lending activities can include extensions of credit to real estate developers, this Section does not specifically address lending activities. (Refer to Handbook Chapter 200, Asset Quality, for guidance on evaluating lending practices.) Many issues of concern to a prudent lender, however, will similarly affect the service corporation as real estate developer (i.e., evaluating appraisals and project feasibility, monitoring fund disbursements and construction progress).

THE REAL ESTATE DEVELOPMENT PROCESS

The service corporation, as developer, is the focal point for the entire development process (i.e., provides funding, selects an appropriate site, determines project feasibility, and monitors construction). The service corporation can act in an individual capacity, in conjunction with one or more development partners, or as a joint venture with others in developing real estate.

The methodology used to design and construct a project will vary among developers and project types (i.e., residential subdivisions, large-scale commercial/retail, industrial properties). The following summary provides an overview of the

service corporation's responsibilities as developer in evaluating and implementing the primary stages of real estate development for virtually all such projects.

Predevelopment

The goal of this stage is to ensure that the site selected by the developer is primed for actual construction. Virtually every tract of "raw" (unimproved) land requires some form of preliminary work before construction may begin. For example, a tract of land may require grading and earth-moving operations to provide a suitable working surface. The costs associated with this stage should be incorporated in the project's overall cost estimates. The service corporation should verify that property represented as fully or almost fully primed for development, is primed for actual construction.

Planning and Design

During this stage, the service corporation performs a qualitative and quantitative evaluation of:

- the architect's drawings and plans;
- supply and demand characteristics of the market;
- comparable projects;
- project suitability factors;
- zoning or public land-use restrictions; and
- private covenants.

One or more architects/engineers (AEs) are typically hired by the developer to provide professional services for project planning, construction and design. For example, construction engineers generally assist in developing and formulating construction plans and evaluating costs. The AE can assist the developer with site planning, landscape engineering and design, selection of suitable building materials, internal and external styling and, in some cases, with supervision of construction.

Construction

The construction stage consists of selecting a contractor, determining construction contract requirements, disbursing funds based on completion of project phases, building the improvements, and monitoring construction progress. A general contractor (GC) has a prominent role in project development as the individual or firm that constructs the project or improvements. The developer should be assured that the GC is fully capable of constructing a quality building in a timely manner, and within the projected construction budget. The need for and ultimate role of the GC is determined by the level of input and control exercised by the developer over the construction phase. The two extremes in this context are when the developer (1) assumes the role of GC and controls the entire construction process, or (2) negotiates an arrangement with an independent contractor whereby little, if any, control is exercised over actual construction activity.

The GC's responsibilities include hiring subcontractors that report solely to the GC. Generally, a direct contractual relationship does not exist between subcontractors and the service corporation developer. To avoid potential difficulties, however, the developer can contractually stipulate that subcontractors hired by the GC must sign and deliver lien waivers of their rights to file mechanics and materialmen's liens and agree not to pass through claims against the GC to the service corporation, as developer.

Marketing for Sale or Lease

The final stage of the development process requires that a marketing program be developed and a marketing team assembled. The marketing program should be based on an analysis of comparable properties and the marketing team should be familiar with the development project and current marketing conditions. Brokers can assist the developer in performing marketing analyses, making sales and rental projections and marketing or leasing the property. If a development project is held for sale or as an income-producing property managed by the developer, an experienced and competent marketing or property management team should be in place prior to completing construction. This will help to ensure timely sales

struction. This will help to ensure timely sales or maximum operating efficiency.

Importance of Competitive Bidding

The service corporation developer should solicit competitive bids from a number of GCs and AEs and thoroughly review all bids received to evaluate the experience, qualifications and track record of each bidder. The winning bidders, of course, should possess the requisite skills, ability and knowledge to efficiently and competently design or construct the subject project.

A competitive bidding process enhances the likelihood of project success and can be applied to all phases of development. For example, design and construction phases that are open to competitive bidding can minimize total development costs. Yet, cost should not be the only factor in selecting a winning bidder. The lowest bidder may not necessarily be the most appropriate entity to hire. As discussed above, the bidder's skills and previous track record must be considered by the developer.

A lack of competitive bidding on any phase of project design or construction must be evaluated to determine whether all contracts awarded were negotiated on an arms-length basis. A service corporation developer can assume substantial risk when competitive bids are not solicited or a contractor's credentials are not verified. The lack of sufficient skill and expertise on the part of any primary project participant can cause substantial losses and have a material effect on a project's feasibility and marketability.

Management Quality

As can be seen, the development process is a succession of steps that require adequate analyses, continued planning, and expertise on the part of all project participants. The competence and expertise of service corporation management with respect to the type of project under construction or development, and the implementation of sound policies and internal controls, are key factors in determining the level of risk presented to a parent thrift. In evaluating real estate development activities, the regulator should be familiar with the overall development

process and the actual real estate project(s) undertaken by the service corporation.

Real Estate Development File

Information pertaining to a project in development can be obtained from the service corporation's files, interviews with staff members responsible for project oversight or for a specific development phase, and, as necessary, visits to the development site. To facilitate audits and OTS examinations, 12 CFR § 563.170 requires that service corporations establish and maintain accounting and other records that provide an accurate and complete record of all business that the entity transacts. Therefore, the service corporation's files should include:

- the property's legal description;
- appraisal information;
- insurance policies or certificate of insurance;
- pro forma financial statements;
- a feasibility study;
- cost estimates for each development stage;
- project plans and designs;
- bid proposals for contracts;
- construction contracts;
- loan applications;
- credentials and qualification statements for consultants or contractors;
- names of individuals or entities that have more than a 10% beneficial interest in the property;
- statements setting forth applicable zoning or deed restrictions;
- flood plan information;
- geology and soil reports; and
- reports provided to the management and directors of the parent thrift and service corporation. (The types and frequency of reports should conform to internal procedures.)

A review of the project development file should provide an understanding of the development project, a framework for evaluating the adequacy of measures taken to contain risk, and an idea of whether the project is proceeding in accordance with a development plan approved by the service corporation's board of directors.

PREACQUISITION ACTIVITY

Prior to acquiring property for development and commencing the overall real estate development process, the service corporation's management must make certain fundamental determinations. These involve:

- the appropriate investment vehicle or form of ownership to use as an "active" developer;
- appraisal information and project feasibility; and
- the project's compliance with local, state and federal regulatory requirements.

The overriding purpose of the preacquisition analysis is to determine whether the project is economically viable as proposed. In this process, certain concerns are of special importance:

Raw Land Acquisition. Generally, the service corporation's real estate development activity involves the acquisition of raw land with the intention of developing the property for sale or lease. There is significant risk associated with the acquisition of raw land due to the numerous variables that are beyond the developer's control. Service corporations, for example, should not acquire tracts of undeveloped land unless they plan to develop and market the land within a relatively short period of time following acquisition. The acquisition of land for speculative purposes can result in land "warehousing" and constitutes an unsafe practice for all but the most experienced real estate developers. The risk associated with warehousing is that the land does not generate income and a future market for the property may not materialize. This can result in land remaining virtually worthless for years.

Risk Control/Project Funds. In performing the preacquisition analysis, risk control should be of fundamental concern to the service corporation en-

gaged in real estate development. Management should be wary of concentrating project development funds in unfamiliar economic or geographic areas in an effort to minimize potential losses associated with economic downturns or unanticipated oversupply in any one market. In addition, a developer can "spread risk" by reducing financial exposure in any one project and spreading development funds among several projects. Thus, development projects should be reviewed on an individual basis and as a portfolio for determining the aggregate risk presented to the parent thrift.

Evaluating Forms of Ownership or Investment Vehicles

Management should evaluate the level of risk associated with various forms of ownership that can be used to invest in a real estate project. The level of risk assumed by a service corporation can vary among investment vehicles based on the extent of the service corporation's ownership obligations, the amount of control that can be exercised over the development process or the financial and managerial resources of development partners or co-venturers.

Typical Investment Vehicles

In evaluating the form of development project ownership, the following should be considered:

Individual Ownership. As an individual owner, the service corporation owns 100% of the development project and can exercise complete control over the project and retain all profits. The service corporation also assumes all risks and liabilities associated with project development. Therefore, this form of ownership can present substantial risk to the parent thrift when management has little or no experience in real estate development activities or undertakes a "first-of-its-kind" large commercial project. Since the service corporation is by definition a corporate enterprise, the extent of potential liability will generally not exceed corporate assets. (Refer to Handbook Section 730, "Maintaining Separate Corporate Identities" and "Piercing the Corporate Veil.")

Joint Venture. Service corporations have used joint ventures to gain expertise and share the risk asso-

ciated with a particular type of development project. The common characteristics of a joint venture include:

- a contribution by all parties of funds, knowledge, skill, expertise, acreage or some other form of assets;
- a right of mutual control or management over the project, although one party may be responsible for project oversight;
- a right to participate in profits generated by the project; and
- an obligation to share losses.

A written agreement should establish the characteristics of the joint venture relationship (i.e., the rights to exercise control or manage the project, contributions of funds, participation in profits or obligations to share losses, additional funding requirements). Generally, a contractual relationship does not exist between the parties to a joint venture agreement and the parent thrift unless the parent has made a direct loan to the joint venture enterprise. Absent a contractual relationship, a third party joint venturer generally has no direct legal recourse to the parent thrift in the event that development problems arise. A material risk associated with joint ventures, however, is the potential for joint and several liability. For example, each joint venturer is individually and collectively liable for damages attributable to negligence by the party supervising the development project. The issue of joint and several liability, highlights the importance of verifying that co-venturers have adequate assets or insurance to address this contingency.

Partnerships (General, Limited, Master Limited).

General partnerships, in essence, are similar in form and function to joint ventures. The entities that comprise a partnership may consist of any combination of sole proprietorships, partnerships and corporate entities. A written partnership agreement or articles of partnership should fully delineate the rights, duties, and obligations of all partners. It should also conform to state regulatory guidelines concerning the formation of partnerships and related filing requirements. [Note: The master limited partnership allows limited partners to purchase interests or units in different projects.

Limited partners do not participate in the partnership's business and are generally liable only to the extent of their investment. A limited partner that exercises any degree of control in managing the development project(s), however, may be perceived as a general partner by a court of law.]

Syndications. Syndications represent both a form of ownership and a financing vehicle. Syndicates can be formed to acquire, develop, manage, operate, or market real estate interests. Generally, a syndicate is comprised of a limited partnership formed by a general partner(s). The general partner often solicits a substantial portion of project funds from a third party lender rather than from the limited partners. The same risks associated with limited partnerships apply to syndicates.

Real Estate Investment Trust (REIT). REITS can own partial or whole interests in real-estate related security instruments. Therefore, REITs can invest in real estate equities or finance any phase of a real estate development project. Only those service corporations that have the requisite experience should establish or manage a REIT. The regulator should determine whether operations are being conducted in a fiduciary manner and in conformance with federal regulatory requirements.

Management's assessment of the level of risk associated with a particular investment vehicle should include a thorough assessment of the track record, expertise and financial resources of development partners. A development partner's inability to meet obligations or perform required responsibilities can materially affect a development project's success. An evaluation of the investment vehicle used by the service corporation should be included in management's initial real estate investment analysis.

Real Estate Investment Analysis

Prior to participating in a real estate development project, the service corporation's management should complete an analysis of the investment's merits. A review of this analysis can provide substantial insight into the initial level of risk assumed by the service corporation. An understanding of management's assumptions and analyses should facilitate a comparison between preliminary projections and the service corporation's overall

investment objectives and any development progress.

In valuing a real property investment, a developer should evaluate:

- the amount of after-tax cash flow that can be reasonably expected (after deducting all expenses);
- appraisal information and overall project feasibility;
- financing alternatives, if necessary;
- the effects of state and federal tax regulations (current and projected) on the project;
- the ability to promptly dispose of the property in a cost-effective manner, if required; and
- the benefits of investing in comparable projects or in other forms of investment vehicles on a risk versus return basis.

Prudent management will use both qualitative (see “Appraisal Information and Overall Project Feasibility”) and quantitative analyses in evaluating risk and anticipated investment returns. The validity of the analyses are directly related to the reliability of the underlying data and assumptions.

Developers will use quantitative tools that provide “rule-of-thumb” comparisons in evaluating the economics of a real estate development project. Historical data can also be used for existing properties. Yet, regardless of the status of a project, the investor should always be aware that real estate markets are subject to change and fluctuation. Two important measures used to compare investments are the net present value (NPV) and internal rate of return (IRR) of after-tax cash flow.

The investment analysis should also address the capabilities of development partners or co-venturers to fulfill their contractual obligations. Just as a prudent lender would thoroughly evaluate a prospective borrower/developer, it is incumbent upon the service corporation to conduct a similar analysis of its development partners. The analysis should include:

- verification of business references;
- a review of experience and track record relating to similar types of projects; and
- an assessment of financial strength through a review of audited financial statements, credit reports, tax returns, and bank accounts.

Consideration should also be given to whether the partner contributes a substantial portion of its own funds and, therefore, is motivated to fulfill its obligations and duties.

All information relating to management’s analysis of real estate investments should be in the service corporation’s files along with ownership agreements, contracts (i.e., partnership or joint venture agreements), and information on the credentials and financial resources of development partners. In addition, an appraisal and project feasibility analysis should be located in the files and incorporated in management’s investment analysis.

Appraisal Information and Overall Project Feasibility

Prior to acquiring property for development or commencing real estate development activity, management should, as previously indicated, thoroughly evaluate appraisal information, overall project feasibility, and compliance with regulatory requirements. The regulator’s review of this analysis is a key aspect in determining the initial level of risk assumed by the service corporation.

The service corporation’s management should perform an independent feasibility study and not rely solely on appraisal information or data provided by prospective development partners and other project participants. Management may, however, use consultants to perform various aspects of the analysis when in-house staff does not have sufficient expertise in a particular area (i.e., environmental hazards, market research, geology or topography). The complete “preacquisition” analysis should be reviewed by the service corporation’s board of directors prior to proceeding with the real estate development process.

Appraisal Information

Much of the information necessary to evaluate the development project can be gleaned from the data presented in a competently prepared OTS “conforming” appraisal. Although not a regulatory requirement, an OTS conforming appraisal may be useful regardless of whether the service corporation is the primary or sole investor, general or limited partner, or borrower or lender. Significant risk is typically assumed by a service corporation that does not analyze an adequate appraisal prior to proceeding with development.

When the development project does not conform to the highest and best use classification as described in the appraisal, it may not be the most profitable use of the land and may pose risk for the service corporation developer. Handbook Section 208, Real Estate Appraisal, provides a detailed discussion on evaluating appraisals and management’s appraisal policies and procedures. In addition, the following should be considered:

- The appraisal will set forth projected construction costs that should be compared to the developer’s estimates. Material differences between the two projections indicate that problems exist with project plans or a lack of expertise on the part of the individuals involved. Such differences should be resolved prior to beginning construction.
- The service corporation should have no direct relationship with the appraiser. The appraiser should certify that he/she has no present or prospective interests in the subject property and no bias with respect to any party associated with the property.
- Appraisals should be current. An appraisal completed many months prior to a developer’s decision to proceed with project development may not be reliable if there have been material changes in the market. A new appraisal report should be obtained when there has been a general decline in market values, the property has been held for an extended period of time, or the service corporation has other reasons to believe that the property or its market has changed.

Since the appraisal is such an important element in determining a project’s overall feasibility, the effect of any appraisal weaknesses on project feasibility should be evaluated.

Feasibility Analysis

Management should independently corroborate or verify the assumptions or conclusions discussed in the appraisal. This can be accomplished during the feasibility analysis. Prior to proceeding with a development project, the service corporation should fully evaluate its feasibility. The specific components that should be addressed include:

Demographics. Demographic components should be fully evaluated to determine whether the project can attract a viable target market. The U.S. Bureau of the Census is a primary source of information on demographics.

Market Analysis. The most significant components of the market analysis include a review of supply and demand characteristics, project desirability, and existing and projected comparables. An integral part of evaluating comparable properties involves the review of rental rates, sales prices, occupancy factors, absorption characteristics, amenities, and physical characteristics. This review generally forms the basis for the assumptions used to compile pro forma financial statements.

Site Analysis. Several variables are evaluated to determine whether the actual site of the project is appropriate from a feasibility perspective. These variables include:

- Project Type - Consideration must be given to whether the development project is suitable for the site.
- Site Configuration - The project should be appropriate to the site on both a cost and aesthetic basis.
- Physical Dimensions - Spatial requirements can vary considerably depending on the type of project involved. Acquiring a parcel of land that is too big may not be cost-effective.
- Current Use of the Property or Adjacent Properties - Surrounding properties should

complement the development project and in no way detract from optimum land use.

- **Geology and Topology** - Rough or uneven terrain or unsuitable soil can significantly affect the value and viability of a parcel or tract of land. Management should use the services of soil engineers to determine whether the land is physically suitable.
- **Easements or Covenants** - A thorough review of public records should disclose if any public or private easements or covenants exist that may adversely affect the project. Potential problems associated with ingress or egress should be identified.
- **Public Utilities** - Costs associated with permits and hook-ups should be accurately projected in the analysis. Public utilities should be readily available and accessible to prevent delays.
- **Zoning and Land-Use Regulations** - The proposed site should conform to existing state and local regulatory requirements. The regulator should scrutinize the value ascribed to a parcel of land that was acquired and does not comply with regulatory requirements. The basis for any assumption that a zoning change will be approved should be documented in the files.
- **Costs of Development** - Costs associated with the site must not be prohibitive. If changes are to be made to the site, management should determine whether the changes are cost-effective. Most sites require some form of preliminary work before they are primed for construction.

Plans and Costs. The plans and costs associated with each phase of development should be evaluated by competent in-house staff or a consultant prior to beginning the construction process. A qualified consultant can assist in-house staff in determining whether plans are accurate and functional and whether related costs are reasonable and realistic. The individual(s) responsible for this review should have the requisite experience for determining whether the project's design is both aesthetically pleasing and functional. (Actual plans and costs, however, can vary considerably from initial predevelopment estimates.)

Pro Forma Financial Statements. The statements should address all stages of project development and provide data for use in determining project feasibility. Pro formas should include the:

- profit and loss statement;
- cash flow statement; and
- operating statement.

These statements are used to determine whether the development project is economically viable and whether additional funding is required. The regulator should review pro formas to determine whether the underlying assumptions and related projections are reasonable based on data contained in the development file. To the extent that development is underway, projections should be compared with actual development activity.

Financing. The service corporation may need to acquire funding for the project. Funding may be obtained through:

- a loan from a parent thrift (or other source) to the service corporation developer;
- a direct loan from the service corporation developer to the project; or
- an outright equity (or ownership) contribution.

The primary issue facing any developer is whether equity or debt financing is the most appropriate financing vehicle. The best financing package should minimize potential financial exposure and maximize potential after-tax return. The regulator should review the service corporation's evaluation of the merits of the financing approach that is selected.

A service corporation developer that requires financing can acquire funds from its parent thrift or from some other source. The service corporation could have difficulty in securing financing due to a lack of experience or proven track record in building a particular type of development project. Management can address this risk by engaging an experienced and capable project development team.

The developer must provide the lender with information regarding its experience, expertise, reputation (including business references), and financial strength. A lender should thoroughly review the financial standing of all related parties to ensure that the developer, contractor and sub-contractors have demonstrated the capacity to successfully complete the type of project under construction.

The regulator should also consider whether the service corporation has overextended its credit and whether the developer provided personal guarantees of loan repayment or other forms of collateral. In addition, the regulator should be familiar with the following forms of financing that a service corporation developer might require and will often negotiate:

- **Interim Financing** - Interim loans (construction loans) are short-term loans usually made during the construction phase of the project. Funds are disbursed incrementally as the construction progresses. Usually, the interim lender will not provide 100% of the funds required to complete construction. The service corporation and its development partners may make up the difference with some form of equity contribution to the project. When the service corporation does not plan to market the development project immediately upon completion, some form of permanent or mini-permanent financing may be required.
- **Permanent and Mini-Permanent Loans** - Permanent loans are long term loans that are generally amortized over 10 to 40 years. These loans are used to fund the acquisition of permanent buildings or provide "take-out" financing for completed projects. Mini-permanent loans offer a borrower/developer an alternative to standard long-term fixed rate financing, and protection against interest-rate increases during the early years of operation. During actual construction operations, the borrower/developer generally remits "interest only" payments on the funds advanced. Following the completion of construction, the borrower/developer will pay a predetermined and fixed-rate of interest on the entire loan. By obtaining this type of loan, the developer typically has several years after the project is completed and operational to either

find satisfactory permanent financing or market the property.

- **Take-Out Financing** - Lenders that provide interim financing may require the developer to obtain a take-out commitment for a third party lender to provide the developer/borrower with permanent financing. The take-out commitment should be of an adequate amount to cover principal and interest that has not otherwise been planned from other sources. When take-out financing is not used, a plan should be in place for paying off the construction loan.

The expiration date, terms and conditions of the take-out commitment should be reasonable and attainable. In addition, the service corporation should verify that the take-out lender is financially capable of funding the permanent loan. Although a take-out commitment may be equitable and reasonable, a developer's deviation from stipulated construction progress could have serious consequences. A take-out commitment that fails to materialize could place the service corporation in a vulnerable financial position and require the parent thrift or a third party to advance some form of temporary financing (i.e., gap loan).

- **Gap Loans** - Gap loans (or bridge loans) are generally used by a borrower/developer to fill a temporary unanticipated need until adequate, permanent financing is obtained. For example, gap financing might be used to "buy time" when permanent financing is either too difficult or too expensive to obtain, the interim lender will not fund construction cost overruns, or the take-out lender will not provide permanent financing until construction is completed. Gap financing is often a "last resort" for a borrower because such funding can involve high interest rates and strict financial constraints to offset the lender's risks. A service corporation developer generally should attempt to find an alternative type of financing whenever possible.

The terms of any financing arrangements should be approved by the service corporation's board of directors and adequately reflected in the entity's pro forma financial statements. When the parent thrift provides interim and permanent financing to its service corporation, it incurs both the construction and market risks associated with the

and market risks associated with the development. As stated above, effective monitoring techniques and internal controls during the construction process should ensure compliance with loan agreements (see “Monitoring Construction Progress” of this Section).

Marketing Program. A market analysis should indicate that a market exists for the specific type of development project contemplated. The service corporation developer assumes marketing risks when an effective marketing plan has not been implemented. A marketing team should be in place prior to completing construction and comprised of individuals who possess the experience and ability to market the project effectively.

Market risks can be minimized when a development project is substantially pre-leased or developed for a specific predetermined purchaser. For example, successful commercial/retail projects are often substantially pre-leased prior to commencing construction. A deficiency in pre-leasing could suggest a potential project failure.

The feasibility analysis must also indicate that a project, as proposed, complies with applicable local, state and federal requirements. A viable project that does not conform to applicable regulatory requirements can lead to substantial costs in attaining regulatory compliance and a possible project failure. Such costs should be reflected in the feasibility analysis.

Compliance with Local, State and Federal Regulatory Requirements

Management’s review of regulatory requirements should address the issues that follow. If the appraisal or project development file does not include an analysis of these issues, the service corporation may have assumed significant and undue risk.

Local Planning and Zoning Ordinances

Land-use restrictions can significantly impede or even prevent project development. An analysis of local planning and zoning ordinances should be provided in a conforming appraisal. If a project does not conform strictly to existing ordinances, a parcel of land will either need to be rezoned or a

variance obtained prior to actual project development.

Local, State and Federal Building Codes

Depending on the type of project involved and its location, numerous jurisdictions may enforce building code requirements. Such requirements might address the property’s accessibility to persons with disabilities (i.e., Americans with Disabilities Act). In certain cases, building codes can be strict and the costs associated with compliance can be significant. These costs can affect a project’s feasibility and should, therefore, be included in development cost estimates. Building code requirements are subject to change, and measures must be taken to ascertain and comply with any new requirements.

Local, State and Federal Fire Codes

Many jurisdictions and insurers require compliance with fire codes. Often this involves installation of fire and smoke alarms, sprinkler systems, and flame and heat resistant construction materials to be included. The costs associated with compliance can be substantial and should be fully projected in project cost estimates. In addition, noncompliance with codes can result in significant financial liability if a fire causes death, serious injury or damages property. The regulator should verify that the project is adequately insured for this type of casualty.

Local, State and Federal Housing Codes

For certain types of residential or multi-family development projects, the service corporation must comply with the Federal Fair Housing Act provisions against discriminatory practices. Most states have developed similar legislation. Moreover, the Department of Housing and Urban Development (HUD) has imposed regulations that may affect the construction and/or marketing of a development project. In addition, when FHA or VA mortgage programs are used to market the project, the service corporation must comply with applicable regulatory requirements.

State and Federal Environmental Regulations

The services of competent professionals should be used to evaluate environmental requirements. Generally, there is a direct relationship between the amount of information and data gathered and evaluated, and the potential risk assumed by the service corporation in this area. When a site can be classified as “suspect,” a formal evaluation should be performed to determine whether contaminants are present. A service corporation can assume significant financial liability if it acquires a contaminated site and can be required to clean up an unusable site at its own (potentially substantial) expense. Sites that have been used for agricultural or industrial purposes, or are close in proximity to landfills, gasoline storage tanks, or polluted waterways, are generally more susceptible to contamination than other types of sites.

Thus, management’s evaluation of a development project’s feasibility, appraisal information and regulatory compliance comprise the initial step (referred to as the preacquisition analysis) in the overall development process. This step is critical for minimizing risk presented to the parent thrift from real estate development activities.

A project that is considered economically viable initially can be adversely affected by factors such as those listed above that can lead to the project’s failure. A high degree of management skill is required to successfully execute any major project. Therefore, service corporations should undertake only those investments that they are competent to manage. An evaluation of management quality should incorporate the relevant guidance and procedures outlined in the Related Organizations Section.

POSTACQUISITION OVERSIGHT AND CONTROL

After the preacquisition analysis is completed, the next step is to acquire the property (i.e., raw land, building, subdivision) and undertake the required stages of development. Postacquisition development activity (the “construction phase”) consists primarily of activity necessary to construct or build improvements on the property for final sale or lease.

The construction stage is the most “cost intensive” aspect of the development process and is comprised of numerous phases. The service corporation developer should analyze all hard and soft construction costs and maintain a record of the value associated with all cost items in the budget. Construction cost estimates should be included in the appraisal and compared to the developer’s estimated construction costs. Material differences between the two projections is often an indication of problems with project plans or lack of expertise on the part of the individuals involved. Such differences should be resolved prior to construction.

From the construction phase forward, a comparison between plans/designs and cost estimates and actual development progress can highlight potential concerns such as: the inability to complete construction within cost and time limitations; construction defects; departures from approved specifications; internal control weaknesses; or fraud related to the misuse of construction funds.

An adequate system for disbursing construction funds and monitoring construction phases is an important aspect of controlling risk associated with development activity. Effective monitoring procedures provide protection to the developer, lender and GC and allow these parties to promptly determine the status of development progress at any time. For example, adequate internal controls and the disbursement of funds pursuant to a budget can likely discourage:

- front-end loading by a borrower, development partner, or contractor to maximize profit at the beginning of construction;
- misappropriation of construction funds by a development partner; and
- excessive retention of fees by a development partner. (Systems for monitoring construction fund disbursements are discussed further in “Monitoring Construction Progress.”)

Construction Contracts

In determining the level of risk associated with construction activity, construction contracts should be reviewed. The construction contract sets forth the rights and duties of the parties regarding costs,

construction scheduling, and default. The service corporation's legal counsel should participate in the preparation of the contract. There are three primary types of construction contracts (i.e., lump-sum or fixed price, cost plus fee, and unit price), the terms of which are primarily determined by the form of compensation to be paid to the builder. A discussion of each type is beyond this Section's scope, but the following elements should be addressed in any construction contract:

The Method of Payment to the Contractor. The review should address:

- any preconditions to payment;
- provisions for inspection of construction imposed by the developer or lender;
- certification procedures by a qualified architect or engineer concerning the builder's eligibility for payment;
- the extent of construction completion required before the builder is entitled to periodic and final payments; and
- any provisions relating to nonpayment of obligations.

Liquidated Damages Provisions. These clauses specify the amount of funds that the builder must pay the developer for any delays in construction beyond a stipulated completion date. Performance or completion bonds can assist in offsetting any damages incurred by a developer as a result of such delays.

Grounds for Contract Termination. Contracts generally include provisions for the builder and developer to receive written notification of a breach of contract. Both parties have an opportunity to cure the default prior to terminating the contract. Generally, the builder may terminate the contract when:

- legal impediments prevent the ability to perform contractual duties and obligations;
- the owner fails to make the premises available for construction;

- payment is not made under established terms; or
- there are other material breaches.

Likewise, the developer may terminate the contract if the builder:

- becomes bankrupt;
- fails to pay subcontractors;
- violates building laws or regulations; or
- is otherwise responsible for a material contractual breach.

Project Scheduling Provisions. A contractual provision should delineate target dates for completing certain phases of construction and the overall project. The three most typical types of monitoring schedules are the Critical Path Method (CPM), the bar chart (GANTT) and the Program Evaluation and Review Technique (PERT). Internal controls and procedures for tracking schedule compliance is important for minimizing risk associated with costly delays and a failure to satisfy the provisions of other agreements (i.e., financing arrangements).

Contingency Reserves. Most construction contracts provide for a contingency reserve. These funds are necessary to cover costs that cannot be identified when the initial construction budget is prepared. (As a general rule, at least 5% of all hard and soft construction costs should be placed in a contingency reserve often referred to as a "holdback.")

In summary, the regulator's review of plans and costs, financing arrangements, and construction contracts should reveal the service corporation's obligations, responsibilities and funding requirements during the construction phase. Based on this information, the regulator should determine whether various techniques have been used to contain risk (i.e., preparation of a budget, adequate contingency reserves, reasonable and attainable contractual obligations, insurance coverage).

Insurance and Bonding Considerations

Management's written policies should address insurance requirements for all parties involved in project development. Prudent developers, GCs, and lenders generally obtain or require other parties to obtain insurance coverage for real estate development activities. Management should ensure that the project is at all times protected from liability and various hazards, and that such protection satisfies the requirements of construction contracts and financing arrangements.

Insurance Coverage

There are numerous types of policies that might be required by parties involved in development activity. Developers that directly participate in construction activities and GCs (as detailed in construction contracts) are generally required to carry:

Builder's Risk Insurance Policies. These policies are generally flexible and cover numerous loss contingencies. For example, a policy could be obtained to cover all of the GC's construction equipment and materials, both on and off the construction site, and protect these items against losses from fire, weather, or other casualties. A construction lender may insist on being named as a "loss payee."

Liability Insurance Policies. These policies insure the GC or developer for claims by third parties for personal injuries or property damage suffered as a result of negligence or misconduct on the part of the GC. Comprehensive policies can also insure against losses caused by subcontractors or other third parties on the construction site.

Workers' Compensation Policies. These policies are required by state law and are designed to provide medical benefits and financial compensation to employees injured on the job. Subcontractors with employees must also carry this type of coverage.

Title and Flood Insurance. A prudent developer (and lender) will also require title insurance coverage. Moreover, for properties located in a designated flood plain, or in an area prone to flood-

ing, a developer will obtain insurance coverage for such losses.

While insurance policies can be obtained to cover virtually every type of loss imaginable in the real estate development context, consideration should be given to whether the cost of premiums justifies the expense. The amount of premiums is often directly related to the track record of the entity being insured. In evaluating a GC, service corporation developers should consider whether the amount of premiums or a refusal to insure is indicative of the standard of care used by the GC on previous construction projects. Construction contracts should require the GC to provide certificates of the prescribed insurance coverages prior to commencing construction operations.

The regulator should verify that there has been compliance with the developer's established policies and all contracts/agreements that require adequate levels of insurance. The service corporation's files should contain certificates evidencing such coverage.

Types of Bonds

Developers can also use bonding to protect themselves from risk of loss. Bonds are obtained by the GC, usually at the behest of the developer. The surety companies that provide bonds act only in the capacity of guarantors, not insurers. In effect, sureties guarantee that they will protect the developer from certain deficiencies that may be exhibited by the GC. The two primary types of bonds that a GC may be required to obtain are:

Performance (Completion) Bonds. The surety guarantees that the project will be completed in conformance with contractual plans and specifications. Generally, these types of bonds are only available to developers that possess an excellent track record and strong financial resources. If this type of bond cannot be obtained, the GC may be unable to fulfill its contractual obligations.

Labor and Materials Payment Bonds. These bonds are designed to provide the developer with limited protection from the claims of unpaid subcontractors and suppliers/materialmen. Coverage can be somewhat limited in terms of the types of creditors

covered and in the total amount of payment tendered.

Thus, bonds provide the developer with a limited amount of protection from the GC's inability to fulfill its obligations. The presence of bonds acts to further minimize the risks associated with real estate project development.

Disbursing Funds and Monitoring Construction Progress

In addition to finalizing financing arrangements and construction contract negotiations, postacquisition activity involves establishing adequate internal controls for disbursing construction funds and monitoring progress. Effective monitoring procedures provide protection to a developer, GC, and lender. These parties should be able to promptly determine the status of construction progress at any time. For example, a prudent lender or a developer will not disburse construction funds until verifying that specified construction phases have been completed or that other phases have commenced. As stated above, an inadequate monitoring system can lead to construction delays, abuses remaining undetected or violations of financing terms, all of which can increase the parent thrift's loss exposure.

Disbursing Construction Funds

Funds should be disbursed to the GC on a scheduled and verifiable basis. In addition, the developer should confirm costs depicted in the budget and verify that work has been completed or that materials were delivered to the site. The "voucher" and "progress payment" systems are two primary disbursement methodologies that might be used by developers.

Voucher System. This disbursement technique is used most often on large-scale development projects. In completing certain phases of construction activities, the GC or other vendor will provide the developer (or lender) with a requisition form, receipts describing the work performed and the materials supplied, and a detailed invoice. This documentation should be compared for accuracy with construction progress reports prepared by the GC. If the amounts expended conform to the value

of the completed activity (as per the budget), disbursements can be made.

Under the voucher system, disbursements can be made by a lender, developer, or third parties (i.e., title or escrow companies). It can be advantageous for the party providing development funds to directly control the disbursement process. This often allows the disburser to closely monitor construction progress. Lenders will generally require that loan agreements contain a disbursement provision. Experienced developers that disburse funds directly may also contractually impose the same type of control. An escrow disbursement procedure can be mutually advantageous when a GC is reluctant to allow the developer to control disbursements or the developer is relatively inexperienced.

All involved parties should thoroughly review and understand how and when disbursements will be made (i.e., types of required documentation, time frames for providing documentation to the disburser). Delays in providing supporting documentation can lead to interruptions in construction that can adversely affect project cost estimates.

Progress Payment System. This disbursement system is generally used on small-scale projects or those with relatively few stages of construction. A borrower/developer could receive a lump sum disbursement from a lender and in turn disburse funds to a GC or the developer could directly disburse its own funds to the GC. In either case, values are specified for the construction phases and disbursements are made accordingly. Although a project may be small in scope, construction progress must be monitored so that disbursements are made to the GC in a timely and prudent fashion.

Monitoring Construction Progress

The techniques used to monitor progress will vary among development projects. The construction project's size, level of complexity (i.e., interrelationships between construction phases), and disbursement requirements should be considered when establishing an appropriate monitoring system. Any monitoring system should be implemented in accordance with written procedures approved by the service corporation's board of directors. The system should, at a minimum, enable the service corporation's management to

the service corporation's management to promptly determine:

- the time frames associated with construction phases;
- the actual stage of completion at any point in time; and
- whether construction is proceeding on schedule and within the projected budget.

A primary focus of the regulator's review should be the evaluation of internal systems for disbursing funds and monitoring construction progress. Due to the complexities associated with specific types of projects and monitoring systems, the regulator should also verify that a qualified individual(s) is overseeing the system's implementation and approving related disbursements. When such controls are inappropriate or nonexistent, the service corporation developer assumes significant risk.

POSTDEVELOPMENT ACTIVITY

The primary aspect of postdevelopment activity involves marketing the property for sale or lease and any other activities that are considered to be "reasonably incident" to real estate development activities under § 545.74 (i.e., managing a home owners association, temporary operation of a water utility for homeowners of a subdivision). A service corporation developer can handle such responsibilities directly through the use of qualified in-house staff or may enter into arrangements with brokers or a third party property management team.

Property Management and Leasing Activities

Professional property management refers to the management of real estate for a fee to maximize tax benefits, capital appreciation or net income associated with real property ownership. The project manager's primary responsibilities are to maximize the property's net income and to successfully conduct marketing or leasing activities. Property owners often use the services of a professional property manager to:

- increase occupancy levels;
- reduce tenant turnover;
- provide expense and income analyses;
- oversee scheduled property maintenance;
- perform accurate record keeping; and
- secure improved tenant relations.

In accordance with § 545.74, federal thrifts may establish a service corporation to provide property management or leasing services. Such services can involve managing the disposition of the parent thrift's REO properties. (Handbook Section 251 provides a detailed discussion of REO and repossessed assets and sets forth appraisal procedures, accounting treatment, and prudent internal review procedures.) The service corporation's management should have adequate expertise or engage the services of an independent, qualified property manager. In addition, project plans and related projections associated with the timely disposition of such properties should be realistic and provide sufficient detail for determining compliance with such activity. Periodic progress reports and financial statements should be forwarded to the service corporation's board of directors.

There are numerous risks associated with property management and leasing services. Certain risks assumed by the property manager or the service corporation in fulfilling their respective duties are insurable. For example, insurance can be obtained to provide coverage for fire, flood, earthquakes, and other forms of casualties. Comprehensive general liability insurance packages cover bodily injury, medical payments, and property damage. In addition, owners, landlords and tenants (OLT) liability insurance can be acquired to insure potential liability arising from property ownership, maintenance, or the use of the insured premises in operations incidental thereto. The service corporation must also comply with insurance requirements of the state in which it operates (i.e., workmen's compensation insurance programs).

Additional risks that are not insurable include violations of state or federal laws (i.e., Fair Housing Act, National Environmental Protection Act), fraud, failure to meet contractual obligations, or

unanticipated downturns in the economy. The regulator should determine whether all insurable risks are in fact insured and whether all other potential risks have been identified and addressed by management.

Profitability relating to the property management function should be a major concern if the service corporation is involved in a high volume business. A number of factors that directly relate to profitability include:

- **The Management Contract** - A definitive management contract should delineate the rights, duties, and obligations of the property owner and the property manager. The contract should clearly define all fees and compensation schedules including any arrangements relating to performance bonuses.
- **Marketing Plan** - To be successful, the property manager and property owner should jointly formulate a formal marketing plan. Realistic goals and objectives should be specified. In addition, the plans should only be developed after a thorough and sufficiently current marketing analysis has been completed.
- **Duty to Maximize Net Income** - A property manager should attempt to maximize the property owner's net income, not only through efficient marketing services and lease negotiations, but also by implementing effective tenant selection processes and rent collection techniques. The property manager should subject the property to periodic income and expense analyses and assess the dynamics of the market place to identify any factors that may adversely affect future income potential. Income and expense projections should be available for future periods and be based on realistic assumptions and sufficient detail that enable the service corporation's board of directors to make informed decisions. The property manager should also take actions to maximize the property's economic life through timely repairs or capital improvements.
- **Accurate Recordkeeping** - The property manager should keep accurate records relating to all phases of property management or leasing activity to provide an accurate and current

financial assessment of the property, and to facilitate the preparation of financial statements, tax returns and reports to the board of directors of the parent thrift and service corporation.

Real Estate Sales

To the extent that a development project, or a portion thereof (i.e., houses within a subdivision), is on the market for sale or in the advanced phases of construction, the regulator should verify that the marketing plan and sales projections are sufficiently reasonable and accurately reflect a current assessment of the local real estate market. When actual sales activity falls substantially below sales forecasts, management should be able to explain the variance and the potential effect of slow sales activity on the service corporation's obligations and overall financial condition.

All real estate sales should be reported on the service corporation's financial statements in accordance with GAAP. Accounting for the sale of real estate is complex and will vary depending on (1) the point at which a sale actually occurs and (2) the way in which the gain on the sale is recognized under GAAP. (For a detailed discussion of accounting for sales of real estate refer to Handbook Section 251, Real Estate Owned and Repossessed Assets, and the Statement of Financial Accounting Standards (SFAS) No. 66.)

OVERALL RISK ASSESSMENT

In determining the overall risk presented to the parent thrift by a related organization, the basic aspects of real estate development, as discussed in this Section, should alert the regulator to potentially unsafe and unsound practices to be evaluated during an examination. For a service corporation that is relatively active in real estate development, it is likely that each development phase will require some form of review consistent with the risk-focused examination approach detailed in Handbook Section 730.

REFERENCES**United States Code (12 USC)***Home Owners' Loan Act*

- § 1464(c) Loans and Investments
- § 1464(t) Capital Standards
- § 1464(t)(5) Separate Capitalization Required for Certain Subsidiaries
- § 1464(t)(5)(D) Transition Rule (For Certain Non-includable Subsidiaries)
- § 1464(u) Limits on Loans to One Borrower

Federal Deposit Insurance Act

- § 1828(m) Activities of Thrifts and Subsidiaries
- § 1831(e) Activities of Savings Associations

Code of Federal Regulations (12 CFR)*FDIC Rules and Regulations*

- § 303.13(d) Equity Investments
- § 303.13(f) Notice of Acquisition or Establishment of a Subsidiary or the Conduct of New Activities Through a Subsidiary

OTS Rules and Regulations*Subchapter A: Organization and Procedures*

- Part 516 Application Processing Guidelines and Procedures

Subchapter C: Regulations of Federal Savings Associations

- § 541.23 Residential Real Estate (Definition)
- § 545.32 Real Estate Loans
- § 545.35 Other Real Estate Loans
- § 545.36 Loans to Acquire or Improve Real Estate
- § 545.37 Combination Loans
- § 545.74 Service Corporations
- § 545.74(c)(3) Permitted Activities (Real Estate Services)

- § 545.74(c)(3)(vi) Acquiring Real Estate for Prompt Development
- § 545.81 Operating Subsidiaries

Subchapter D: Regulations Applicable to All Savings Associations

- § 561.30 Nonresidential Construction Loans
- § 563.37(b) Service Corporation Debt
- § 563.93 Loans to One Borrower
- § 563.100 Real Estate Lending Standards
- § 563.101 Real Estate Lending Standards
- § 563.170 Examinations and Audits; Appraisals; Establishment and Maintenance of Records
- § 563.170(c)(1) Records with Respect to Loans Secured by Real Estate
- § 563.172 Re-evaluation of Real Estate Owned
- Part 567 Capital
- § 567.1(h) Eligible Savings Association (Definition)
- § 567.1(i) Equity Investments (Definition)
- § 567.1(aa) Subsidiary (Definition)
- § 567.9(c) Deductions From Capital (Investments in Nonincludable Subsidiaries)
- § 571.18 Accounting Per Troubled Debt Restructuring
- § 571.26 Classification of Assets

Accounting Practices*Financial Accounting Standards Board - Statements of Financial Accounting Standards (SFAS)*

- No. 34 Capitalization of Interest Cost
- No. 58 Capitalization of Interest Cost in Financial Statements that Include Investments Accounted for by the Equity Method
- No. 66 Accounting for Sales of Real Estate
- No. 67 Accounting for Costs and Initial Rental Operations of Real Estate Projects
- No. 98 Sale-Leaseback Transactions Involving Real Estate

Accounting Principles Board - Opinions (APBO)

- No. 18 The Equity Method of Accounting
for Investments in Common Stock
- No. 21 Interest on Receivables and Pay-
ables

*AICPA Accounting Standards Division -
Statements of Position (SOP)*

- No. 78-2 Accounting Practices of Real Es-
tate Investment Trusts
- No. 78-3 Accounting for Costs to Sell and
Rent, and Initial Rental Opera-
tions of, Real Estate Projects

No. 78-4

Appreciation of the Deposit, In-
stallment and Cost Recovery
Method in Accounting for Sales in
Real Estate

No. 78-9

Accounting for Investments in
Real Estate Ventures

No. 80-3

Accounting for Real Estate Ac-
quisition, Development and
Construction Costs

No. 81-1

Accounting for Performance of
Construction-Type and Certain
Performance-Type Contracts

Real Estate Development Program

Examination Objectives

To determine the level of risk that the related organization's real estate development activities present to the parent thrift and to implement corrective actions as necessary.

Examination Procedures

Level I

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- | | | |
|-------|---|-------|
| 1. | Perform the appropriate examination procedures in Handbook Section 730. | |
| <hr/> | | <hr/> |
| 2. | Review the previous report of examination and all real estate development-related exceptions noted and determine if management has taken appropriate corrective action. | |
| <hr/> | | <hr/> |
| 3. | Determine the type(s) of development projects and/or services in which the related organization engages. | |
| <hr/> | | <hr/> |
| 4. | Determine the risk associated with speculative practices (i.e., acreage warehoused for future development or disregard for negative factors pertaining to initial market or site analyses). | |
| <hr/> | | <hr/> |
| 5. | Identify any concentration of development funds and determine the materiality of the risk involved. | |
| <hr/> | | <hr/> |
| 6. | Confirm that the qualifications and expertise of individuals assigned the primary responsibilities for overseeing real estate operations have been thoroughly evaluated and verified. | |
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Level II

7. Verify that the related organization has established and adheres to minimum documentation standards regarding real estate activities.

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8. Determine the extent to which the related organization's procedures and internal controls serve to identify and control risk. Specifically, review a selected sample of asset files to:

Preacquisition Activity

- Ascertain the role(s) assumed by the related organization (i.e., property manager, developer, GC, lender and/or leasing manager) and other primary project participants.
- Verify the results of management's risk versus return analysis. (Are underlying assumptions reasonable and based on adequate analyses?)
- Determine whether management is making fundamental decisions concerning market characteristics, development costs, project constraints (i.e., physical, environmental, zoning), financing alternatives, and project feasibility.
- Verify that the service corporation has thoroughly evaluated its development partners' reputation, experience, expertise, and financial capabilities. (Do partners have the capacity to meet financial and other obligations? Can personal guarantees be enforced?)
- Determine the adequacy of management's project feasibility analysis. (Does the site meet suitability and desirability requirements? Was the site evaluated for environmental hazards? Are future after-tax cash flow and development cost estimates realistic? Are construction plans and designs reasonable, cost-effective and based on sound assumptions?)
- Ascertain whether an appraisal was prepared by a qualified appraiser and whether the information was evaluated and verified by management. (See Handbook Section 208, Real Estate Appraisals.)
- Verify that management has taken action to ensure that real estate activities comply with local, state, and federal regulations (i.e., planning, zoning, housing codes, and

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environmental restrictions).

Postacquisition Oversight and Control

- Determine the related organization's form of real estate ownership (i.e., active, passive, joint venturer, general partner, limited partner) and related risk factors.
- Identify the organization's obligations and those of other parties as set forth in contracts, agreements, or other legally binding arrangements. (For example, how are profits, losses or additional funding requirements to be divided among general partners? What are the equity contributions of each development partner?)
- Ascertain whether management is effective in ensuring compliance with the terms and conditions of financing arrangements.
- Determine the risk related to financing arrangements for development activities and any guarantees made by the parent thrift or the service corporation developer. (What is the potential liability regarding loans from the parent to the service corporation, joint venture or partnership?)
- Determine whether competitive bidding is used for awarding contracts and the adequacy of the service corporation's evaluation of contractors and consultants.
- Verify that construction contracts and measures for enforcing compliance with related provisions are effective in minimizing risk associated with development activity (i.e., provisions for inspection of completed phases, project scheduling, grounds for termination).
- Verify that projects are sufficiently insured and bonded.
- Evaluate the adequacy of systems for monitoring development progress and disbursing funds. (Do fund disbursements conform to predetermined cost estimates?)
- Compare development plans, budgets and marketing strategies to practices and progress. (Trends or material variances that may violate contractual obligations and/or effect project viability or marketability should be explained.)
- Confirm that the value of the land and any improvements are at least equivalent to the total amount of funds disbursed.

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- If material, assess the effect of any economic changes since the onset of development on the project's feasibility.
- Determine the amount of any contingent or other potential liabilities.

Postdevelopment Activity

- Determine whether projections pertaining to leasing or sales activity are reasonable and whether established goals have or will, in all likelihood, be attained.
- Verify that marketing plans are based on a sufficiently current market analysis.
- Determine whether income and expense projections are reasonable (i.e., brokers' fees, leasing arrangements).
- Ensure that gains and losses on property sold are properly recognized in accordance with GAAP.

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9. Evaluate financing arrangements, sales/purchases of real estate or other transactions with affiliates or insiders to determine their effect on the service corporation or its parent thrift.
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10. Verify that the organization's real estate activity and related transactions are properly accounted for under OTS capital reporting requirements. (See Handbook Section 730 for a discussion of OTS and GAAP reporting requirements pertaining to a thrift investment in a related organization(s).
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Examiner's Summary, Recommendations, and Comments

Exam Date: _____

Prepared By: _____

Reviewed By: _____

Docket #: _____